

The Indonesian Quarterly

Fourth Quarter 2011

Vol. 39 No. 4



The New Globalism

Matthew J. Bock

Anwar Nasution

Jusuf Wanandi

Trans-Pacific Partnership

Jusuf Wanandi and Raymond Atje

European Interest

Manuel Schmitz

Political Islam

Geoffrey P. Macdonald

Review of Developments

Deni Friawan

Philips J. Vermonte

Centre for Strategic and International Studies

The Indonesian
Quarterly
Fourth Quarter
2011
Vol. 39, No. 4

The Indonesian Quarterly is a journal of policy oriented studies published by the Centre for Strategic and International Studies (CSIS), The Jakarta Post Building 3rd Floor, Jalan Palmerah Barat No. 142-143, Jakarta 10270, Indonesia. It is a medium for research findings, evaluations and views of scholars, statesmen and thinkers on the Indonesian situation and its problems. It is also a medium for Indonesian views on regional and global problems. The opinions expressed in *The Indonesian Quarterly* are those of their authors and do not necessarily reflect the opinion of the CSIS.

The Logo



To better represent the underlying ideas that gave birth to CSIS in 1971, the Centre uses as of 1989 the logo that figures on the front cover of this journal. The original, in bronze, was designed by Indonesia's renowned sculptor G. Sidharta and comprises a disc with an engraving of the globe, which serves as a backdrop to a youth with an open book on a cloth draped across his lap, his left hand pointing into the book, and his right raised upwards. All these elements combine to project the Centre's nature as an institution, where people think, learn and share their knowledge. Mankind is their concern and the world their horizon. The undressed torso symbolises open-mindedness and the absence of prejudice in the attitude of the scholars who work with the Centre, just as it is with scholars everywhere. The inscription reads "Nalar Ajar Terusan Budi", in the Javanese language, conveys the Centre's belief that "to think and to share knowledge are the natural consequences of an enlightened mind." It is a *surya sengkala* that is *chandra sengkala* - a Javanese traditional way to symbolise a memorable year in the lunar calendar, adapted to the solar calendar system. It uses words that express the perceived meaning of the commemorated year while marking the year at the same time, with each word having a numerical value. Thus, the inscription, in reverse order, represents the year CSIS was established: 1971.

Editors

Sunny Tanuwidjaja, Fajar B. Hirawan, Nancy K. Suhut, Maria Monica Wihardja

Advisory Board

Rizal Sukma, Raymond Atje, Medelina K. Flendytio

SIT

01381/SK/Dirjen PG/SIT/72

ISSN

0304-2170

The Indonesian Quarterly

Fourth Quarter Vol. 39 No. 4, 2011



The New Globalism

Leveraging Internationalism: Indonesian Perceptions on the G20

Matthew J. Bock

349-367

The world has seen a profound shift in global governance as nation-states have sought dialogue and diplomacy in response to the 2008 Global Financial Crisis, not isolation or condemnation. The G20 has been called upon by the international community to display collective leadership guiding countries through crises, and to refine the financial system making it responsive to the priorities of emerging economies. John Kirton maintains that the G20 is forum for G7ization: transmitting core G7 interests and norms to a wider set of countries crossing geographical, political, economic, and religious divides; however, these ideals remain in question. Indonesians are distrustful towards globalization partially due to the legacy of the 1997 Asian Financial Crisis. This study uses Indonesia as a case study to build a G20 narrative from 2008-2011 to examine sources of scepticism. Overall, scepticism has shifted over time, but G20 enthusiasm remains high as the benefits from the international exposure Indonesia receives far outweigh the threats while leadership and continuity are of greatest concern. Looking ahead, 2012 is not the time to push for a formalized secretariat but to rely on the troika system for agenda continuity. To enhance the legitimacy of the G20, Indonesia must prioritize domestic connectivity and establish the basis for a green economy as promised in 2009.

Keywords: G20, perceptions, G7-G20 relations, international financial governance, scepticism

Implications of Global Financial Sector Regulatory Reforms on Emerging Economies

Anwar Nasution

368-381

In response to the Global Financial Crisis (GFC) of 2007-2009, the G20 Summit Meeting in Seoul on November 11-12, 2010, endorsed Basel III as the core element of the new financial regulatory framework. Basel III was mainly designed for banks in advanced industrialized economies with mature and well-developed financial markets. It primarily covers standards and regulations on shadow banks and complicated derivatives that do not exist in the emerging economies. To build effective and efficient financial markets, it strongly

recommends the use of credit rating and credit scoring systems, and stress testing, all of which are difficult to implement in emerging economies. This is because of the weaknesses in the market infrastructure of the developing economies due to a combination of relatively weak legal and accounting systems, limitations on data availability, and the dominant role of state-owned enterprises, including in the financial system. Hence, it fails to address the needs of emerging economies that increasingly occupy a prominent role in global finance.

Keywords: Basel III, financial regulatory reforms, shadow banks, financial and banking institutions

Global Power Shift and Asia

Jusuf Wanandi

382-394

The Chinese economy has now become the center of East Asian economy, because of the demography that has defined the size of the Chinese economy for our region and the world, and also due to the increase of productivity, thanks to investments in education and R & D. Since East Asia has become an enormous economy, the importance of the region has also increased. When in the previous decades the US defined the politics and security of East Asia, the future of the region's strategic development will be more complex.

Keywords: East Asia Summit, China, United States, South China Sea, Trans Pacific Partnership

Trans-Pacific Partnership

Trans-Pacific Partnership Initiative: An Indonesian Perspective

Jusuf Wanandi and Raymond Atje

395-418

When in the previous decades the US defined the politics and security of East Asia, the future of the region's strategic development will be more complex. China, who likes to accept a certain role for the US in the region, is now asking what the U.S. role should be for the region's future. Basically the relationship between China and the U.S. is partly cooperation and partly competition. So, while it is not expected that a war or major conflict will take place between them in the foreseeable future, the development of the relationship is now at a crossroad. The latest trend is that the U.S. is returning her attention to Asia Pacific, because its involvements in the Middle East, Iraq and Afghanistan are becoming less heavy and it understands that the Asia Pacific, especially East Asia, is going to be the most important economies not only globally, but also to get the U.S. economy grow again. For East Asia, the U.S. economic restoration is the most important factor to guarantee that she can become the unalienable part of East Asia.

Keywords: East Asia Summit, ASEAN, South China Sea, Trans Pacific Partnership, United States

European Interes

Europe's interests in Indonesia: What is to gain from closer cooperation?

Manuel Schmitz

419-432

While the European Union (EU) and its member states focus more and more on emerging powers such as China and India, the regional power Indonesia seems to suffer from benign neglect. Despite the democratic nature of its political system that should make Indonesia a natural ally for Europe the Southeast Asian state is not considered to be a strategic partner for Europe. Against this background the article asks what Europe has to gain from closer cooperation with Jakarta, why it is in Europe's interest to focus more on Indonesia. The first part of the paper deals with security issues, such as piracy in the Strait of Malacca and Islamic terrorism. Then Indonesia's economic potential as investment location, market for European products and source of raw materials is analyzed. The last section focuses on the diplomatic arena and highlights Jakarta's importance in various contexts of global governance (such as the fight against climate change or the management of the current global economic crisis). Be it as member of G20 or as key player in ASEAN, Indonesia should not be ignored by an EU eager to find global partners to overcome its current problems. Indeed, Europe's interests in Indonesia are substantial and the EU should invest more in the bilateral relationship.

Keywords: European Union, Indonesia, diplomacy, economic relations, security

Political Islam

Islam and Party Politics in Indonesia: An Assessment of the 2009 Election

Geoffrey P. Macdonald

433-449

Indonesian politics is rife with contradictions. Islamic parties are performing worse across election cycles even while conservative legislation is passed and violence continues against "heretical" Islamic sects. Surveys indicate that Indonesians are becoming more "rational" in their assessment of governmental performance, yet also show strong support for Shariah law. In this complex political environment, how do political parties appeal to voters during elections? Are voters' rational instincts cultivated with innovative policy proposals? Or is general support for Shariah law exploited with conservative appeals? This paper investigates party strategy during the 2009 election using a content analysis of parliamentary and presidential campaign statements. It finds that parties employed significantly more policy-based rhetoric during the 2009 election and, importantly, that the content of this rhetoric was largely the same across parties. This interchangeability of party rhetoric undermines election competition and enervates Indonesian democracy.

Keywords: Islam, Indonesian politics, election, political party

Review of Developments

Outlook Remain Bright, Amid Turbulent Time

Deni Friawan

450-462

The Year of Living Dangerously (for Certain Minority Groups)

Philips J. Vermonte

463-467

Leveraging Internationalism: Indonesian Perceptions on the G20

*Matthew J Bock*¹

Introduction

Amidst the instability following the Great Depression, totalitarian regimes emerged that led the world into total war; amidst the instability of the 2008 Global Financial Crisis (GFC), states deepened connectivity and opened new channels of dialogue. The G20, the premier forum for state leaders to engage in intimate diplomacy and demonstrate collective leadership, has emerged seeking to prevent economic collapse, political condemnation, or conflict. Yet, even as the acclaimed forum considers establishing a permanent secretariat, the group receives dispraise and public protest at each Summit. Criticism stems from the initial country-selection process which lacked transparent criteria and circumvented the UN system thus creating a legitimacy deficit.

Opinions of elites within emerging economies have the ability to delegitimize the G20 forum through either public censure or private dissent. Analyzing G20 perceptions within emerging economies will enhance understanding of the scale and sources of scepticism to increase sensitivity towards important issues. John Kirton maintains an argument that the G20 is a medium for 'G7ization': transmitting core G7 interests and norms to a wider set of countries crossing geographical, political, economic, and religious divides. But what are these norms and interests: Are they liberalism and economic stability, or inequality,

¹ Matthew J. Bock recently graduated from UBC in Vancouver, Canada, with an MA in Asia Pacific Policy Studies and he has a BA in International Studies. Matthew was a visiting researcher at CSIS.

dependency and exploitation due to neoliberalization and globalization? This study is not a normative assessment; rather, the goal is to construct a G20 narrative and judge if it includes a significant level of 'G7ization' concern.

Indonesia, the world's 4th most populous country and largest Muslim democracy, has been propelled onto the world stage in part due the G20's rise to prominence. Furthermore, due to the legacy of the 1997 Asian Financial Crisis (AFC), Indonesia serves as a useful case study to examine domestic perceptions of the G20. This study will use a mixed-method approach to trace Indonesia's G20 narrative between 2008 and 2011. To analyze why shifts in perception occurred over the three-year period, current literature will deepen the narrative by linking G20 activities to domestic priorities.

Overall, this paper will demonstrate that elite enthusiasm towards G20 participation remains high as Indonesia profits from the prominence of the forum, and the resultant international exposure supports Indonesia's nascent middle-power identity, thus overshadowing threats of G7ization. Based on this conclusion, three recommendations are offered for 2012: Indonesia must continue to use G20 exposure to pursue an investment-grade credit rating; to implement a REDD+ framework, stream-line land registration and business licensing, and enhance internal connectivity to establish a green economy as promised in Pittsburgh 2009; and to focus on domestic transparency to ensure the Indonesian delegation makes verifiable claims at the G20 forum.

G7ization: A Component of Globalization?

Currently, the G20 is questioning its future structure: should the group deepen formalization and establish a permanent secretariat or continue to rely on the troika system for agenda continuity? In part, the G20's edifice determines its future role in international economic governance. Will enthusiasm for the forum wane once the international financial system returns to a state of stability and the demand for collective leadership decreases? Or will the G20 acquire sufficient legitimacy through broad-based, prudent governance and continue working to improve the stability, equality, and reach of the international financial system? Legitimacy is central to determining the G20's future.

John Kirton, a prominent G20 analyst, presents the group as a manifestation of the G7/8, a dominant core seeking to serve its own interests. In 2000, he argued that the G20 would remain important serving to reinforce the leadership of the G7/8 by ensuring initiatives were 'bought into'.² In 2008, due to entreaties by George W. Bush for a multilateral response to the GFC, the Washington Ministerial Summit was held. In response, Kirton reported that the work of the G20 "has been guided by the directions and decisions set by the G7 finance ministers".³

For ten years, Kirton consistently maintains that the G20 is a medium for G7ization. In an overall assessment, he concludes:

*The G8's foundational mission of globally promoting open democracy, individual liberty, and social advance has already been steadily infiltrating the work of the G20 devoted to financial stability and economic equity; therefore, the G8 ideals are likely to win out in the end.*⁴

If this is the G20's *raison d'être*, are emerging economies also perceiving the G20 in such a fashion? For the purposes of this study, G7 'ideals' are considered part of an invasive process diminishing Indonesia's decision-making autonomy by pressuring the country to implement G20 policies which were not designed for Indonesia's best interest, but for the interests of the G7 core.

Alternatively, Geoffrey Garret postulates that the G20 serves ostensibly as a multilateral forum but this is a veneer for the true nature of the institution, namely, a forum to nest China-US—the G2—geopolitical tensions.⁵ Similarly, Yves Tiberghien views the G20 as a 'G3' discordant triad—the EU, USA, and China—who dominate agenda setting in attempt to steer policy toward each one's advantage by us-

² John Kirton, "The G20: Representativeness, Effectiveness, and Leadership in Global Governance" in John Kirton et al., ed., *Guiding Global Order: G8 Governance in the Twenty-First Century* (London, England: Ashgate Publishing Ltd., 2000), 143-172.

³ John Kirton, "The G8-G20 Roles and Relationship," prepared for *The Future of the G8-G20* (Brussels, May 13, 2010), 1-19, available online: <http://www.g20.utoronto.ca/biblio/index.html#kirton-g20-g8-g5> (accessed 15 November, 2011).

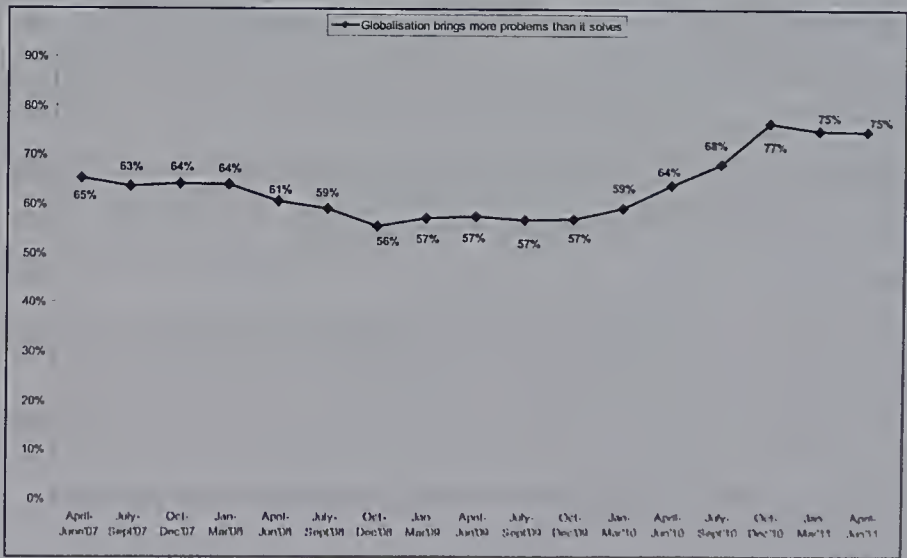
⁴ John Kirton, "Coexistence, Cooperation, Competition: G Summits," *Aspenia*, Vol. 43-44 (June 2009), 156-162.

⁵ Geoffrey Garrett, "G2 in G20: China, the United States and the World after the Global Financial Crisis," *Global Policy*, Vol. 1, No. 1 (January 2010), 29-39.

ing the forum to engage in caucusing and to enhance credibility.⁶ This paper does not repudiate these claims nor assess which abstraction—the G2, the G3 or G7ization—is correct, but each theory will deepen the narrative.

Since the 2008 GFC shifted the G20 into the center of international financial governance debates, Indonesia has brought a new voice to international as well as regional affairs. Numerous oft-cited statistics acclaim Indonesia’s dramatic economic rise to become the 16th largest economy, implying that Indonesia is justified in steering international affairs even though it maintains low-middle income status.⁷ Excitement and obvious benefits aside, is Indonesia in the midst of a historical moment due to a convergence of factors which have the country punching above its weight? The year 2011 had Indonesia as chair of ASEAN and hosting the East Asia Summit while a renewed interest in multilateralism emerged as the second wave of the financial crises unfolded in the US and the EU. If this is a historical moment, what does this mean for Indonesian in 2012 and beyond?

Figure 1. Indonesian Perception on ‘Globalization’



Source: Roy Morgan Data

⁶ Yves Tiberghien, *East Asian Politics and the Great G20 Game: Convergence and Divergence in Chinese, Korean and Japanese Approaches.*, Working Paper, EAI Fellows Program (UBC, April 2011).
⁷ See: Robert Pringle, "Indonesia's Moment," *The Wilson Quarterly*, Vol. 35, No. 1 (Winter 2011), 26-33, Peter Drysdale, "Indonesia's Global Role," *East Asia Forum*, available online: <http://www.eastasiaforum.org/2011/09/19/indonesias-global-role/> (accessed 2 November 2011), Aubrey Belford, "Indonesia: Innovation and Invocation," *World Policy Journal*, Vol. 28, No. 2 (2011), 26-43.

The legacy of the AFC runs deep in Indonesian (or at the island of Java's) collective memory as the externally generated crisis triggered economic collapse, social collapse, and political collapse.⁸ As shown in Figure 1, scepticism towards 'globalization' has remained high over the last four years ranging from 57-77%. Interestingly, general public opinion on 'globalization' declined throughout the early days of 2008 but this confidence was short-lived as the events of 2010 ushered in a new era of rising scepticism. Unpacking the root causes of these shifts is beyond the scope of this analysis; however, as an institution which enables and supports globalization, this trend impacts perceptions on the G20. The hypothesis in this essay is that there will be a significant group of elite sceptics, reflecting the attitude of the general public, who actively criticize the G20. If Indonesia faces difficult economic times due to contagion, this scepticism ultimately may turn public support against the G20, hampering the current administration's ability to implement policy.

Content Analysis Methodology

To construct Indonesia's G20 narrative, a systematic content analysis was employed to establish a quantitative breakdown of G20 rhetoric. White and Marsh argue that this methodology allows "the researcher [to use] analytical constructs, or rules of inference, to move from the text to the answers to the research questions".⁹ Since this study is focused on perceptions, capturing Indonesian rhetoric surrounding the G20 is considered reflective of public opinion, albeit an elite opinion due to the technocratic nature of the forum.

Although an English language newspaper, *The Jakarta Post* is oft-cited by scholars and was the only media outlet to dispatch a correspondent to G20 summits or maintain a consistent G20 narrative. Furthermore, the working language of the G20 is English while G20 activities remain absent from the rhetoric of day-to-day domestic issues, so elite opinions in *The Jakarta Post* are considered valid. The terms

⁸ Hal Hill and Takashi Shiraishi, "Indonesia After the Asian Crisis," *Asian Economic Policy Review*, Vol. 2 (2007), 123-141

⁹ Marilyn D. White and Emily E. Marsh, "Content Analysis," *Library Trends*, Vol. 55, No. 11 (Summer 2006), 22-45.

“G-20” or “G20” were searched and each entry was analysed, coded, and recorded which led to the creation of a searchable database. The author’s language was coded as either a) supportive of Indonesia and the G20, or b) sceptical of Indonesia’s involvement within the G20 to judge the general atmosphere surrounding each Summit. Articles that demonstrated specific ‘G7ization’ concerns were counted separately. Table 1 summarizes the indicator terms and correlated themes for each classification.

Two different time periods were used: a) from Autumn, 2008 until Autumn, 2011 to produce a general G20 narrative and b) from January 1st, 2011 until November 12th, 2011 for an in-depth look into the Cannes Summit. This first period contains all six Ministerial Summits so, for logistical reasons, the period was broken down into six ‘windows’—one week before the two-day Summit and one week after (154 articles in all).

Table 1. Summary of Content Analysis Search

Classification	Indicator Terms	Themes
Supportive	consensus, united, peers, solving, appreciates Indonesia, contributed, key role	<ul style="list-style-type: none">- G20 is legitimate.- G20 is effective.- Indonesia contributes to the common good.
Sceptical (General)	inept, worthless, ineffective, non-binding, talk shop	<ul style="list-style-type: none">- Indonesia should focus on other institution.- Focus on bilateral relationships.
G7ization	fairness, outcomes, cleavages, caucus-ing, caution, liberal-ization	<ul style="list-style-type: none">- Indonesia should defend interests.- Caucus with non-G7.

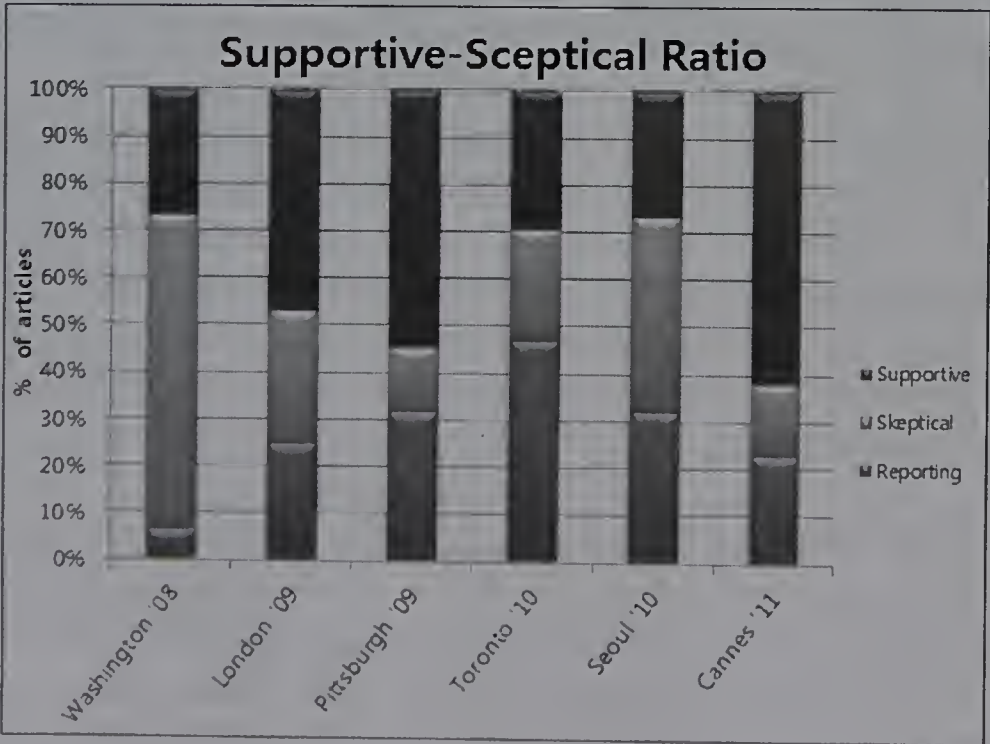
For the in-depth look into Cannes, only opinion pieces or direct correspondences were included to remove general reporting or business analysis. To be considered relevant, an article had to offer specific

criticism, policy prescription, or hypothesize about future implications. A variety of authors contributed including domestic and international scholars, government officials including the President, foreign diplomats, members of the business community, representatives from civil society, and representatives from international institutions. For 2011, 63 articles were extracted and coded.

Content Analysis Results

The results from 2008-2011 are displayed in Figures 2 and 3. Figure 2 shows the percentage breakdown of all articles indicating a supportive-sceptical ratio. This ratio introduces the general atmosphere surrounding each Summit, while ‘reporting’ articles—basic factual statements - are also reported. Note that for ‘Washington ‘08’, *The Jakarta Post* did not dispatch a correspondent to the Summit hence the low volume of factual reporting.

Figure 2. Summit Atmosphere

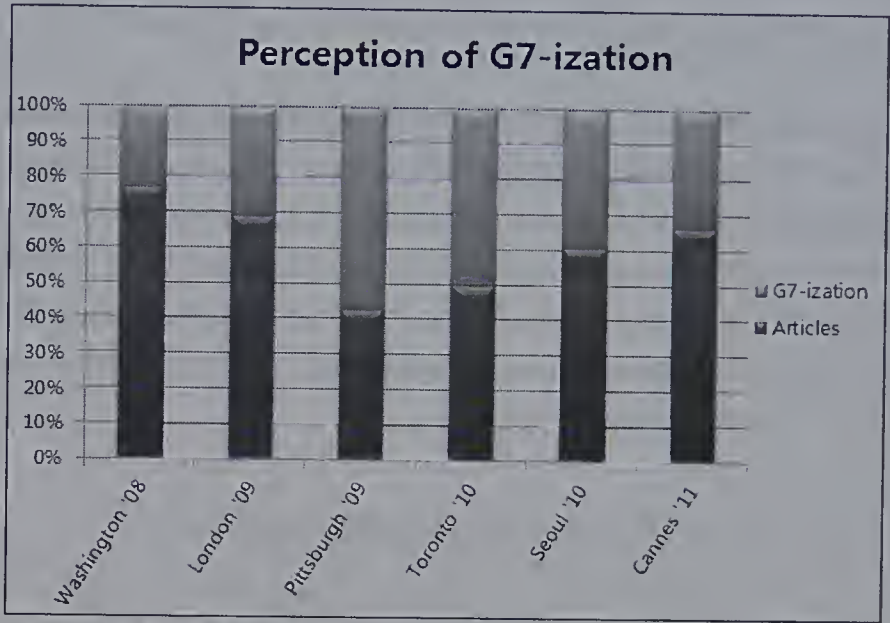


Source: Author’s calculation

Specific to the G7ization question, Figure 3 displays the amount of ‘G7ization’ articles as a percentage of total non-reporting articles. This

graph demonstrates how prominent were G7ization concerns in comparison to general apprehension towards the legitimacy or effectiveness of the G20. As shown below, initially G7ization was of little concern, then spiked at Pittsburgh 2009, and since has decreased steadily.

Figure 3. G7ization



Source: Author's Calculation

The matrix below in Table 2 summarizes the data from Figures 2 and 3. The 'atmosphere' column corresponds to Figure 2: whichever category—'supportive' or 'sceptical'—had a greater percentage of articles defines the atmosphere. The Washington '08 and Seoul '10 Summits had a 'sceptical' atmosphere while the rest were 'supportive'. The 'G7ization Concern' column corresponds to Figure 3 as the 'rising-declining' indicator offers comparison to the previous summit.

Table 2. Results Summary

Summit	Atmosphere	G7ization Concern
Washington '08	Sceptical	Not significant
London '09	Supportive	Rising
Pittsburgh '09	Supportive	Rising
Toronto '10	Supportive	Declining
Seoul '10	Sceptical	Declining
Cannes '11	Supportive	Declining

Part One: Shock and Awe

The 2008 Washington Summit prioritized international coordination in response to the unfolding GFC, and was the first opportunity for Indonesian President Yudhoyono to engage intimately with the world's most powerful leaders. Interestingly, the Summit atmosphere was 'sceptical' due to George W. Bush's low popularity combined with a lingering historical distrust in part due to the turmoil of 1997. In Washington, hot money flowing into and eventually out Indonesia concerned the delegation so officials strived to limit high levels of fluctuation as Indonesia's sizable foreign currency reserves were insufficient to insulate the domestic economy. As the long-term relevance of the forum was still unknown, appreciating the strategic advantage of G20 participation also remained elusive.

Specific G7ization concerns were present but comparatively low as general concern about the urgency and uncertainty of the GFC overshadowed ideological scrutiny. After the Summit, in a letter printed in *The Jakarta Post*, President Yudhoyono expressed specific frustration about G7 prioritization as he states, "developing countries cannot help but feel they are being punished for something they did not cause".¹⁰ He made these statements despite the fact that the final communiqué included language recognizing the unique challenges faced by emerging economies, and the G20's adoption of the Emergency Expenditure Fund which Indonesia helped construct.¹¹

In 2009, American President Barack Obama, who is massively popular in Indonesia, was newly elected, thus enthusiasm towards the second G20 Summit in London peaked contributing to the 'supportive' atmosphere. The G20 was receiving international recognition so the delegation could use the forum to expand its middle-power identity while the Indonesia elite began to appreciate the long-term strategic advantage of participation. Due to the rapid evolution of the crisis, procedural norms were still ad hoc while public expectations remained convoluted due to persistent financial uncertainty. Consequently, authors

¹⁰ Susilo Bambang Yudhoyono, "President Yudhoyono's View of the G-20 Summit," *Jakarta Post*, 18 September 2008.

¹¹ For full contributions see: Zamroni Salim, "Indonesia in the G20: Benefits and Challenges Amidst National Interests and Priorities," in Wilhelm Hofmeister, ed., *G20: Perceptions and Perspectives for Global Governance* (Singapore: Konrad-Adenauer-Stiftung, 2011), 95-107.

began to question the nature of the forum causing a rise in G7ization concerns. HS Dillon, former executive of *The Partnership for Governance Reform* in Indonesia, notes the privilege of being in the G20, but shows concern for Indonesia's capacity to affect change. He states "the only way President SBY can save himself from being deemed a 'free-rider' will be for him to try and make a meaningful contribution to the meeting of world leaders" (Dillon, 2008).¹² Academics were conceptualizing what the long-term international and regional impacts were for Indonesia as they now had inside track into the Bretton Woods Institutions.

The 2009 Pittsburgh Summit saw a spike in G7ization articles producing the highest level of concern within the three-year period. This surge of G7ization articles reflects the preponderance of statements by G7 leaders, including Prime Minister Gordon Brown, making declarations that the G20 would replace the G7/8 as the elite decision-making forum. The sceptical trend demonstrates that the G7 actively was shaping a G20 identity. Conversely, Indonesian stakeholders remained reticent about proclaiming the pre-eminence of G20, or of its long-term capacity to enhance equality between developed countries and emerging markets.

During the Summit, G2 issues overshadowed the agenda: China-US trade imbalances and debates surrounding currency re-evaluation dominated talks resulting in a cleavage in the group. The Pittsburgh '09 communiqué included language to maintain a commitment to the development agenda, and specifically to mitigate impacts on emerging economies. After Pittsburgh, the G7ization surge receded, declining steadily towards Cannes. Conversely, Kornelius Purba offered a stark reminder that "[In the 1990s] Indonesia was the golden boy of the World Bank, the International Monetary Fund and Asian Development Bank... [b]ut our economy crashed to zero", indicating the presence of distrust and G7ization concern.

Part Two: Recovery

By the Toronto 2010 Summit, internal tensions between Indonesia's competing commitments to accommodate national interests, ASEAN interests, and the general interests of emerging economies

¹² HS Dillon, "A Tough Test for President Yudhoyono's Soft Power," *Jakarta Post*, 2 April 2009.

became apparent. The persistence of G7 leaders lauding the G20 provoked criticism from national, regional, and international institutions. Furthermore, public opinion was also critical as media attention on the G8/G20 consecutive Summits, and the ensuing protests in Toronto, resulted in a significant decrease in supportive articles.

Protest activity, however, was insufficient to sway elite support for the G20 forum as the atmosphere remained 'supportive'. G7ization scepticism declined from Pittsburgh as, along the President Yudhoyono's GHG emissions declaration, the G20 proved responsive to procedural concerns. Upon Indonesia's recommendation, the G20 included the ASEAN chair, Prime Minister Nguyen Tan Dung of Vietnam, and Singapore's Prime Minister, Lee Hsien Loong, as members of the Global Governance Group (3G). Also, the delivery of tangible results regarding the restructuring of the IMF and WB quota systems was instrumental in reducing G7ization concerns. However, the perceived threat from G7ization still remained as an Indonesian economist stated "developed nations usually will ask emerging countries, like Indonesia, China and India to follow what they want".¹³

The 2010 Seoul Summit is interesting because the atmosphere turned 'sceptical' even as the G7ization concern steadily declined. In the lead-up to the Summit, Kornelius Purba states "you may think the way to resolve issues is through the G20. But at the end of the day, nothing binding happens. The policies that will help Indonesia come from Indonesia. Indonesia is on its own".¹⁴ Recovery from the GFC continued but an element of Summit burnout set in.

Consequently, seemingly due to the volcanic eruption of Mount Merapi, President Yudhoyono wavered on attending the Seoul Summit resulting in the Korean President, Mr. Lee Myung-bak, calling the night before to petition for President Yudhoyono's attendance. The absence of an Asian member would have been damaging to the reputation of the G20. President Yudhoyono arrived late and chaired the anti-corruption discussions. In the end, based on the groundwork established in Pittsburgh, the G20 produced the *Seoul Development Con-*

¹³ Mustaqim Adamrah, "Gradual Deficits Cut Should Be Followed by Rise in Investment.," *Jakarta Post*, 20 May 2010.

¹⁴ Kornelius Purba, "The Shows of South Korea, Japan and Indonesia," *Jakarta Post*, 11 April 2010.

sensus for Shared Growth which prioritized an Indonesian national interest: stable infrastructure investment. Conversely, G2 currency talks overshadowed the summit which relegated the *Development Consensus* to an issue of second-tier importance.

After the Summit, Shanti Shamdasani, an ASEAN consultant, released an article summarizing the sceptical tone of the G7ization surrounding the Seoul Summit. He states that “we must not be tolerant to the idea that we are used by various parties to become a country of buyers and not sellers; a country that can be exploited down to its last drop of sand, a country so tolerant that we will oversee the abuse and misuse of our people and resources.”¹⁵ After two years of recovery, and a degree of stability, a deeper level of questioning emerged about the norms behind the G20 and its general ideational construction.

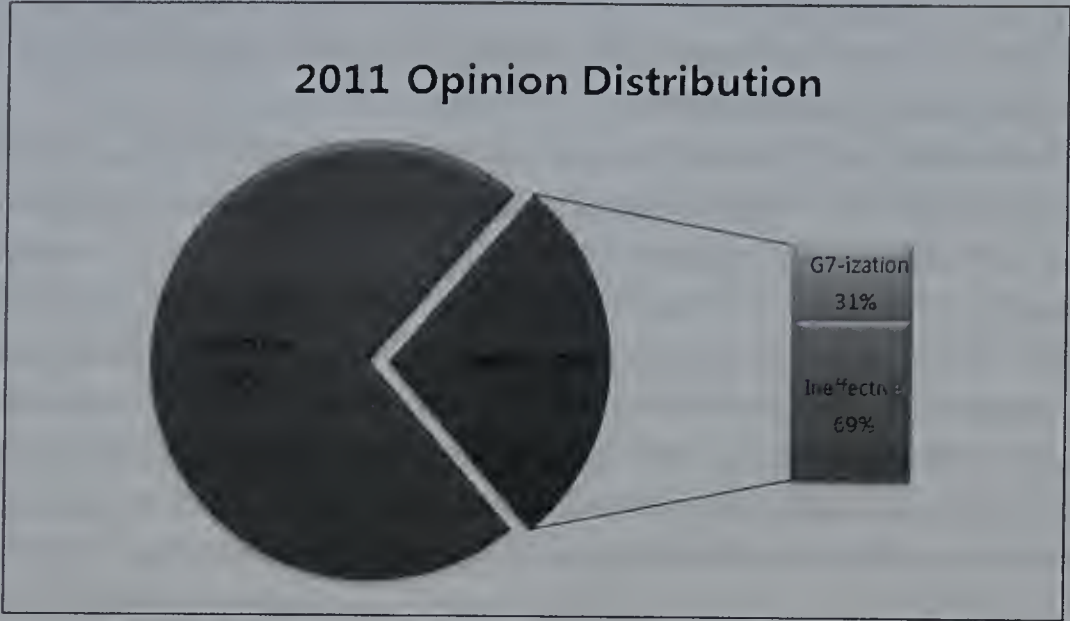
Part Three: The Road to Cannes

The Cannes Summit directly preceded the APEC, ASEAN and East Asia Summits, while the US debt and EU financial crises spurred a renewed interest in collective leadership. Figure 4 gives a detailed breakdown of the 2011 articles showing that 72% of authors are ‘supportive’ indicating that Indonesia’s G20 presence was appreciated within the domestic sphere. Within the 28% that were sceptical, the majority (69%) voiced a generalized scepticism. An example of generalized scepticism is typified by Maria Monica Wihardja’s conclusion as she states “there is a global leadership vacuum. The most important question right now is who will (and can) lead. Leadership is costly and no one cares to pay”.¹⁶ Along with leadership, agenda continuity and effectiveness were the largest sources of concern.

¹⁵ Shanti Shamdasani, “Obama Urges India to Lead, Applauds RI,” *Jakarta Post*, 16 November 2010.

¹⁶ Maria Monica Wihardja, “2011-2012 Difficult Years for the G20,” *Jakarta Post*, 21 October 2011.

Figure 4. Summary of 2011 Perceptions



Source: Author's Calculation

Although the volume of scepticism motivated by apprehension towards a perceived G7ization was the minority in 2011, the theme remained present as 31% of sceptical articles voiced this concern. The snap decision to replace the head of the IMF, Dominique Strauss-Kahn, with another European, Christine Lagarde, sparked questions about how seriously the non-G7 recommendations regarding IMF rebalancing had been taken. In June 2011, Hank Lim and Simon Tay, two academics from Singapore, specifically asked whether Asia needs the IMF at all, or maybe it is time to re-think an Asian Monetary Fund. They state "but [IMF] votes and, even more, the attitude of Europeans lead to doubts the IMF can sufficiently evolve to reflect the dynamic realities of global rebalancing".¹⁷ They were not alone in voicing this concern.

Yayan GH Mulyana released several articles throughout the year commenting on the long-term implications of the G20. In one article, he highlights an institutional tension that is difficult to reconcile: the G20 and the Non-Aligned Movement. He states that "at the 2005 [Non-aligned] Summit, the Bandung Principles were enriched. New norms and values were embraced... For younger generations of the country, however, the conference and its meaning have unfortunately turned

¹⁷ Hank Lim and Simon Tay, "Does Asia Need the IMF?," *Jakarta Post*, 7 June 2011.

out to be less appealing..."¹⁸ The author recognizes the utilitarian need to manage the global financial system with collective leadership due to the threat of contagion, but laments Indonesia's loss of independence in charting its own direction.

Generally in 2011, specific concerns about G2 or G3 issues dominating the agenda trumped ideological fears of G7ization or a nefarious Bretton Woods policy agenda. Indonesia is a highly-network country belonging to myriad international organizations so authors remained reticent to express overt criticism of the IMF or World Bank. Resistance was expressed through recommendations to deepen the ASEAN community, expand bilateral activities, or seek policy co-ordination with BRICS. These organizations are not mutually exclusive, nor is balancing institutional commitments a zero-sum game; however, involvement requires much planning and preparation, as any G20 Sherpa can attest, so prioritization is zero-sum regarding bureaucratic task delegation.

At Cannes, the original agenda was supposed to further the actions of the *Seoul Development Consensus*, but the agenda failed to receive the attention it deserved. Due to the capricious winds of crisis, Greece's unfolding economically-driven political drama overshadowed the prescribed G20 agenda and supplanted it with Euro-centric priorities. During day two of the Summit, aspects of the original agenda were addressed resulting in a final communiqué that appears balanced, although the process was anything but. The *Action Plan for Growth and Jobs* recognizes the priority of food security and infrastructure in long-term recovery.

Consequently, the post-Cannes reaction was less supportive. Of concern was that of a two-tier agenda setting process would emerge in which 'core' issues maintain priority while development, environmental, and investment issues are relegated to the second tier. After the Summit, Mulyana stated "one challenge to the French presidency has been how to ensure that the G20 process is not Eurocentric at this juncture".¹⁹ Regarding Indonesia's enthusiasm for the G20 in 2012 and

¹⁸ Yayan GH Mulyana, "The 1955 Bandung Conference and its Present Significance," *Jakarta Post*, 24 April 2011.

¹⁹ Yayan GH Mulyana, "G20, Leadership, and Crisis Response Diplomacy," *Jakarta Post*, 11 April 2011.

beyond, the question becomes whether G20 collective interests meet Indonesian's national interests or whether Indonesia can continue to use the G20 forum to advance its middle-power aspirations.

Throughout 2011, President Yudhoyono remained enthusiastic for the G20 as it serves his personal goal to cultivate "zero enemies, and a million friends" by acting as a bridge-builder. International recognition related to G20 activities supports the idea of Indonesia as a burgeoning middle-power country. Since January 1st, both the Hungarian and Swedish governments have extended invitations to deepen diplomatic, educational, and bilateral trade relations which enhance Indonesian's legitimacy as a middle-power. Hungary and Sweden's stated motivations are indicative of this reality as both diplomats stated that Indonesia's membership in the G20 influenced their decision to deepen each relationship.

Analysis: Leadership at Pittsburgh

The Pittsburgh Summit requires analysis as it was a turning point: the Summit had the highest level of G7ization concern, but this concern declined consistently towards Cannes. By 2009, perceptions remained supportive partially due to the active role that Indonesia had taken at G20 meetings. The Indonesian delegation consistently offered meaningful contributions to G20 collective efforts.²⁰ Furthermore, President Yudhoyono was strategic in framing national objectives and domestic needs as win-win for the international community. The manner in which President Yudhoyono introduced policy, both internationally and domestically, is of interest. At Pittsburgh, the newly re-elected President surprised both his domestic and international audiences by announcing Indonesia's ambitious greenhouse gas (GHG) emissions reduction plan. He claimed that Indonesia will cut emissions output by 26% unilaterally or by 41% with international support while lacking either solid evidence or a coherent implementation plan.²¹

²⁰ For a full list see: Salim, "Indonesia in the G20: Benefits and Challenges Amidst National Interests and Priorities," 103.

²¹ Frank Jotzo, "Reaching for the sky?," *Inside Indonesia*, (25 July 2011), available online: <http://www.insideindonesia.org/edition-105-jul-sep-2011/reaching-for-the-sky-18071461>, (accessed 22 November 2011).

Albeit risky, President Yudhoyono outlined two disparate alternatives: a) the business as usual reduction plan and b) the alternative, which included an additional 15% reduction rate with international support (i.e. international money, and lots of it). He framed the situation as win-win by using language that was inviting for both the international and domestic spheres. By tabling such an ambitious plan, and coupling it with a pro-growth, pro-employment strategy, developed countries were receptive to the idea of an emerging economy taking a leadership role. By broadening the scope of the G20 to include environmental issues, legitimacy for the technocratic institution also increased. Domestically, as international coffers for emissions reductions programs had swollen in recent years, local Indonesian officials had incentive to pass the legislation and unlock new investment sources, bilateral assistance programs, and corruption opportunities.

In terms of using the G20 forum to drive domestic reform, and to enhance Indonesia's international identity, President Yudhoyono played a variant of a two-level game. Robert Putnam defines a two-level game as the process by which an agent engaged in multilateral negotiations must negotiate iteratively at both the international and domestic levels.²² Usually, a negotiating agent works with domestic actors—affected stakeholders, and political parties—to formulate initial interests. Next, the agent will negotiate at the international forum to find a solution that meets the needs of the group without relinquishing core issues. Finally, the agent will return to the domestic sphere to implement the agreement. At Pittsburgh, President Yudhoyono did the opposite as he unilaterally announced an ambitious position within the international arena, which pressured competing domestic interests to coalesce around the idea. Failing to enact the legislation would threaten Indonesia's international credibility thus exposing domestic parties to criticism. Why did President Yudhoyono risk Indonesia's credibility?

The ability of Indonesia's executive to pass legislation is hampered as *Reformasi* prevents unilateral, centralized policy implementation. The executive and legislative bodies are coalitions of political parties

²² Robert D. Putnam, "Diplomacy and Domestic Politics: The Logic of Two-Level Games," *International Affairs*, Vol. 42, No. 3 (1988), 427-460.

lacking a coherent policy direction. Stephen Sherlock states there is “a lack of any real sense of a ‘government party’ in parliament” and “that party leaders exercise little day-to-day control over ordinary members of their caucuses”.²³ Comprehensive party platforms remain vestigial while the national legislature maintains a political culture in which parties “share power far more than they fight over it”, resulting in a degree of perpetual legislative paralysis.²⁴ In a political milieu such as this, and coupled with endemic corruption, charting a policy direction in accordance with the priorities of the G20, or with pressing domestic needs, proves difficult so President Yudhoyono’s seemingly brazen strategy appears rational.

After Pittsburgh ’09, the President was heralded as the ‘hero’ of the Summit by civil society, but legislative action emerged more slowly.²⁵ Two years later, the Indonesian legislature finally passed the *Presidential Regulation No. 61 Year 2011 for Greenhouse Gas Emission Reductions* using exactly the percentages and language that President Yudhoyono used in 2009, even though BAPPENAS still lacked a plan to implement the legislation.²⁶

Recommendations

Overall, apprehension due to a malicious G7ization process is not significant within the Indonesia’s domestic elite audience as overall support is high at 72%. Leadership, continuity, and effectiveness far outweigh critical assessments; therefore, three recommendations are offered to enhance domestic support which increases the G20’s overall legitimacy.

First, Indonesia’s rise to prominence has been catalyzed by its high economic growth rate in conjunction with its large population, its stable democratic practices, and its strategic location. Consequently,

²³ Stephen Shylock, “The Parliament in Indonesia’s Decade of Democracy: People’s Forum of Chamber of Cronies?” in Edward Aspinall and Marcus Mietzner, ed., *Problems of Democratisation in Indonesia: Elections, Institutions and Society* (Singapore: ISEAS Publishing, 2010), 160-178.

²⁴ Dan Slater, “Indonesia’s Accountability Trap: Party Cartels and Presidential Power after Democratic Transition,” *Indonesia*, Vol. 78 (2004), 61-74.

²⁵ Jonathan Wootliff, “Why Indonesia emerged as the true hero at G20,” *Jakarta Post*, 29 September 2009.

²⁶ Maruhum Batubara, “Greenhouse Gas Emission Dissemination,” *Jakarta Post*, 7 November 2011.

the short-term objective is clear: maintain prudent fiscal management until an investment-grade credit rating is achieved to reduce financial dependence on donor countries. *Standard and Poor* currently rates Indonesia as BB+, one notch below investment grade, although analysts predict an upgrade in 2012.²⁷ Greater economic autonomy will create space to caucus and to negotiate during G20 discussions. In the meantime, Indonesia must further leverage the G20's international presence to boost bilateral opportunities and shore-up investor confidence. An investment grade rating, will allow Indonesians to capitalize on their entrepreneurial spirit and nationalistic sentiments to fold existing informal activities into the formal sector.²⁸

Second, beyond continuing to press for more equitable international representation vis-à-vis further IMF and World Bank reform, Indonesia must strive to ensure that development issues, and the *Seoul Development Consensus*, are not relegated to second tier discussions or derailed by G2/G3 prioritization. Simple lobbying will be insufficient; leadership by example is required, therefore, existing G20 policy recommendations must be internalized and brought to the ground level. In Indonesia, grounding policies will reduce the high degree of public scepticism towards globalization thus enhancing G20 legitimacy.

Already President Yudhoyono increased international and domestic expectations due to his proclamation at the 2009 Pittsburgh Summit, so Indonesia must develop a functional REDD+ mechanism and establish a framework for a green economy to meet its new GHG reduction targets. Indonesian officials often advocate for regional and international connectivity, but domestic connectivity is the current bottleneck as land registration, business licensing, and rural infrastructure inhibit the development of small and medium enterprises. Rising income inequality and regional disparity limit economic growth, diminish Indonesia's reputation, and hamper social development. Indonesia must look internally to gain influence internationally.

²⁷ Muhamad Al Azhari and Dion Bisara, "S&P Upgrades Indonesia's Credit Rating," *The Jakarta Globe*, 9 April 2011.

²⁸ Rizal Sukma, "Domestic Politics and Indonesia's International Posture," *East Asia Forum*, 2011 available online: <http://www.eastasiaforum.org/2011/10/18/domestic-politics-and-indonesia-s-international-posture/#more-22293> (accessed 24 October 2011).

Third, recently the Indonesian government has made substantial progress in enhancing internal connectivity, but a focus on transparency within the process is required to improve public perception and to build credibility at the G20 forum. The House of Representatives is scheduled to sign the land acquisition bill to increase rate of internal development and social equity. To enhance domestic legitimacy, Indonesia must ensure quality human development from increased infrastructure development, not only higher growth rates. By having open and transparent domestic systems, Indonesian leaders will be able to demonstrate G20 leadership by making verifiable claims, unlike in Pittsburgh, on issues important to Indonesia's domestic population and to other emerging economies.

By successfully implementing a profitable, sustainable development model, Indonesian can become the archetype for inclusive growth in emerging economies. Infrastructure and associated investment needs of emerging economies can continue to be framed as win-win for developed countries and lending institutions.²⁹ As recently presented in *The Economist*, with a ranking of 16th, Indonesia has been falling behind on implementing G20 policies so the country needs to show leadership not just by tabling issues, but by following through on commitments already made.³⁰

²⁹ Peter Drysdale, "Indonesia's Global Role," *East Asia Forum*, available online: <http://www.easiaforum.org/2011/09/19/indonesias-global-role/>, (accessed 24 October 2011).

³⁰ Economist, "Grading the G20: This Time They Really Mean It," *The Economist*, 3 November 2011.

Implications of Global Financial Sector Regulatory Reforms on Emerging Economies¹

Anwar Nasution²

Introduction

The purpose of this paper is to analyze the implications of the Basel III on the modernization of the financial systems of emerging economies, particularly in East and Southeast Asia, and their movement towards the market-based system. Basel III was mainly designed for banks in advanced industrialized economies with mature and well-developed financial markets. It primarily covers standards and regulations on shadow banks and complicated derivatives that do not exist in the emerging economies. To build effective and efficient financial markets it strongly recommends the use of credit rating and credit scoring systems and stress testing. These recommendations are difficult to implement in emerging economies because of weaknesses in the market infrastructure of the developing economies due to a combination of relatively weak legal and accounting systems, limitations on data availability, and the dominant role of state-owned enterprises, including in the financial system. State-owned banks and companies in these countries are implicitly guaranteed by their owners as they are the implementers of the industrial policies of governments. Meanwhile, private banks are intertwined with their business affiliates. Laws and

¹ A paper delivered at "Conference on Cooperation for Sustainable Growth and Development, View from G20 Countries," jointly organized by ICRIER of India, the IMF, the World Bank, the Konrad Adenauer Stiftung of Germany, Chatam House of the United Kingdom, and the ADB Institute, Gulmohar Hall, India Habitat Centre, New Delhi, 13-14 September 2011.

² Anwar Nasution is a Professor of Economics, University of Indonesia

regulations in the underdeveloped economies are also difficult to enforce in the public sector and against politically well-connected business groups.

In response to the Global Financial Crisis (GFC) of 2007-2009, the G20 Summit Meeting in Seoul on the 11th and 12th of November, 2010, endorsed Basel III as the core element of the new financial regulatory framework. It is the basic foundation for transforming the global financial system, coordinated by the Financial Stability Board (FSB), so as to build a safer financial system and ensure its resilience to periodic stress tests. Basel III was developed by the Basel Committee on Banking Supervision (BCBS) and adopted by the Group of Governors and Heads of Supervision of the member countries of the BIS in July 2010. A higher global minimum capital standard for commercial banks was agreed on September 12, 2010.

Basel III comprises of three areas designed to strengthen regulation and supervision of the banking system. Firstly, improving the banking system's ability to absorb shocks arising from financial and economic distress. The focus on common equity mitigates the "too big to fail" problem and forces the bank to bear the cost of the failure they have imposed on society. Secondly, improving risk management and governance of the banking system and, thirdly, upgrading transparency and disclosure. The Basel III framework covers both micro as well as macro prudential regulations. The micro type of regulations helps strengthen the resilience of individual banking institutions, while macro prudential regulations address wider risks that can build up across the entire banking system and the whole economy.

Bank Capital under Basel III

Basel III is not only a firm-specific, risk-based structure but also a system-wide and systemic risk-based framework,³ which upgrades the standards relating to capital, liquidity and leverage in the banking system. The combination of new micro- and macro-prudential reforms addresses both institution- and system-level risks. Basel III is more

³ Hannoun, Herve. 2010. "The Basel III Capital Framework: a decisive breakthrough," a paper presented at BoJ-BIS High Level Seminar on Financial Regulatory Reform: Implications for Asia and Pacific. Hong Kong SAR, 22 November.

specific in defining the capital adequacy ratio: the capital ratio itself, the numerator of the solvency ratio or the capital, and the denominator or the risk-weighted assets. To mitigate the "too big to fail" problem, Basel III focuses on common equity, the highest quality component of a bank's capital. This forces banks to bear the costs of the failures they have been imposing on society. In addition, Tier 1 also includes other instruments such as retained earnings, other reserves and certain preference shares that have a loss-absorbing capacity on a "going concern" or solvency basis.⁴ Innovative capital instruments, which are currently permitted in limited amounts, will be phased out. Tier 2 capital will be simplified. It typically consists of subordinated debt and provides loss absorbing capacity on a "gone concern" basis following insolvency and liquidation. Tier 3 capital used to cover a portion of a bank's market risk capital charge is to be phased out and deductions from capital will be harmonized.

Basel III uses a stricter definition of core capital and simplifies and harmonizes deductions and filters that are applied to its calculation, particularly in calculating Tier 3 capital. Stricter criteria are now to be applied to other qualifying financial instruments that can be included in the calculation of capital and certain types of assets of questionable quality are excluded from the calculation. Basel III corrects the complex set of minimums and maximums of various elements of capital (Tier 1, Tier 2 and Tier 3) that was employed by Basel II. Before the Global Financial Crisis of 2007-2009, for example, global banks raised their leverage by investing the Tier 1 component of their capital in debt-like or hybrid "innovative" instruments. The stricter definition of capital level under Basel III upgrades the quality and significantly raises the required level of capital, improves its transparency and disclosure, and makes the capital adequacy of global banks comparable. The higher capital quality required will make banks stronger, improve their loss-absorbing capacities and allow them to withstand periods of stress.

There are three components of bank capital under Basel III, namely: (i) a minimum common equity requirement, (ii) a conservation buf-

⁴ Hannoun (2010) defines "Tier 1 capital is loss-absorbing on a "going concern" basis (i.e., the financial institution is solvent. Tier 2 capital absorbs losses on a "gone concern" basis (i.e., following insolvency and upon liquidation").

fer, and (iii) a countercyclical buffer. The capital conservation buffer is to enable banks to maintain capital levels above the minimum requirement throughout a significant sector-wide downturn. This conservation buffer should be phased in by January 2019 at the latest. National bank supervisors have more discretion in implementing the countercyclical capital buffer.

Table 1. Strengthened capital framework: From Basel II to Basel III

In percent- age of risk- weighted assets	Capital requirements							Additional macropru- dential overlay	
	Common equity			Tier 1 Capital		Total capital		Coun- ter- cyclical buffer	Additional loss-ab- sorbing capacity for SIFIs*
	Mini- mum	Conser- vation buffer	Re- quired	Mini- mum	Re- quired	Mini- mum	Re- quired	Range	
Basel II	2			4		8			
Memo:	Equivalent to around 1% for an average international bank under the new definition			Equivalent to around 2% for an average interna- tional bank under the new definition					
Basel III New definition and cali- bration	4.5	2.5	7.0	6.0	8.5	8	10.5	0 - 2.5	Capital surcharge for SIFIs?

*Modalities to be defined

Source: Caruana, Jaime. 2010. "Basel III : towards a safer financial system," a paper delivered at the 3rd Santander International Banking Conference, Madrid, 15 September.

The three components of bank capital should be raised through a combination of raising capital in the market, and restricting discretionary payments such as dividends, share buybacks and bonuses to shareholders, employees and other capital providers. The restriction of discretionary distributions of banks' earnings will shift the risk as much as possible from depositors to shareholders and employees of banks.

Tabel-1 shows that Basel III raises the minimum common equity requirement to 4.5% of risk-weighted assets (RWA) from 2% under Basel II. In addition, a bank is required to hold another 2.5% of RWA as

a capital conservation buffer to face economic stress. On top of these requirements, Basel III also requires banks to create a countercyclical buffer of between 0% and 2.5% of RWA during periods of excess credit growth. In total, therefore, banks need to maintain a common minimum required equity ratio of 7% of RWA. The Tier 1 minimum capital requirement is increased from 4% to 6% of RWA. Total Tier 1 capital needed to be maintained by a bank is therefore equal to 8.5 % of RWA. While the total capital requirement of a bank has been increased from 8% in Basel II to 10.5% of RWA in Basel III, "there remains the more difficult (if not impossible) job of setting accurate risk weight against which to measure capital"⁵.

The countercyclical capital buffer in Basel III makes Capital Adequacy Ratio (CAR) high during a boom period and low during a sluggish period. This partly corrects the inherent pro-cyclicality of the capital regulation and mark-to-market accounting of Basel II that could precipitate an unnecessary crisis. The shortcoming of mark-to-market valuation of credit collaterals is a fundamental accounting issue faced by banking regulators and supervisors all over the world. Mark-to-market accounting distorts valuations during periods of market volatility when the long-term value of assets differs from their market prices. Forcing excessive write-downs during a period when asset prices are below their fundamental values may lead to fire sales of illiquid assets that would result in a vicious circle of spiraling asset price devaluation.

The countercyclical capital buffer serves two purposes. First, to allow banks to grant credit during the period of stress and thereby prevent sudden drops in bank credit and the amplification of cyclicality through the banking system that would push the real economy deeper into recession. The second purpose of the countercyclical capital buffer is to dampen credit growth or to act as a brake on bank lending that can cause asset price bubbles as its accumulation raises costs to the banking system. In reaction to capital shortages, banks can also reduce investment in risky assets in favor of safer investments, rather than raise additional capital.

⁵ Scott, Hal, 2011. "Little to celebrate on Dodd-Frank's birthday", *Financial Times*, Wednesday, July 20. p. 8.

The countercyclical buffer helps ensure the availability of bank capital to support ongoing business operations and credit extension during the period of stress. A sudden stop in bank credit during a period of stress creates a further decline in asset prices and increases non-performing loans that could precipitate an unnecessary crisis. This self-defeating process results in bank loans becoming scarcer. The capital buffer should be built up during times of economic growth to be used as a cushion to absorb losses in times of stress.

The increase in the level of capital requirements, better quality and transparency of the capital base, and better risk capture will increase the cost of banking and could curtail lending so as to negatively affect economic growth. To ease this, the Basel Committee has provided an ample 8 years transition period for banks to adjust to the new Basel III standards, i.e., from 1 January 2013 to 1 January 2019. This will allow the banking industry to satisfy the higher capital standards through retained earnings and other measures to raise capital.

The Financial Stability Board is still working on how to design the best framework for the oversight of systemically important financial institutions (SIFIs). It is broadly recognized that the loss absorbing capacity of systemically important banks should be higher than the Basel III standards. According to Cecchetti (2010), this can be achieved by a combination of a systemic capital surcharge, the potential of bail-in debt to oblige lenders to these firms to bear some of the risk if the SIFI should fail, and contingent capital or financial instruments that can be written off or converted to common shares under certain conditions⁶.

Like the systemically important financial institutions, there are also systemically important markets and systematically important infrastructure that go to the heart of the financial system in mature industrial economies. However, such rules on investment portfolios are irrelevant to banks in emerging economies that still rely on deposits and loans. The GFC in industrial countries in 2007-2009 indicates that the financial crisis originated from the trading book, particularly the complex securitization exposures such as collateralized debt obligations

⁶ Cecchetti, Stephen G. 2010. *Financial reform: a progress report.* Remarks prepared for the Westminster Economic Forum, National Institute of Economic and Social Research, London. 4 October.

(CDO). The collapse of Lehman Brothers in 2008 indicated that the low capital charge on OTC (over-the-counter) derivatives did not capture the systemic risk associated with the interconnectedness and potential cascade effects in these markets. The Basel Committee has endorsed central counterparty clearing houses (CCPs) and trade reporting on OTC derivatives in order to resolve the problem of interconnectedness. The CCP system improves the management of counterparty risk, simplifies multilateral netting of exposures and payments, and increases transparency. To encourage the use of CCPs, the Basel Committee has suggested charging lower capital treatment for their use than those applied to bilateral OTC transactions.

To supplement the shortcoming of the VAR (value-at-risk) model that uses a normality assumption, the Basel Committee has encouraged banks to conduct periodic stress tests that better capture tail events and incorporate the systemic risk dimension in banks' risk management. Stress testing is an integral part of the internal capital adequacy assessment and capital buffer calculation processes under Pillar 2. Stress testing is, however, meaningless as long as banks are implicitly guaranteed by government.

Basel III introduces a leverage ratio to constrain the build up of leverage in the banking industry. The current proposal by the Basel Committee is to test a leverage ratio of 3 percent of Tier 1 as part of the Pillar 2 supervisory review with a view to migrating this to a Pillar 1 requirement by January 1, 2018. There are two standards being proposed to ensure liquidity of bank assets. The first is the Liquidity Coverage Ratio to ensure that banks have sufficient high-quality liquid assets that can be easily converted into cash at low cost in order to meet cash outflows for a 30-day period during a severe market shock. The second standard is the Net Stable Funding Ratio that is intended to promote long-term funding, such as capital, preferred stock and debt maturities of more than one year or short-term deposits that can be renewed.

Moving to a Market-based System

To promote sustainable long-term economic growth, the Basel core principles and standards require the building of an effective and efficient market with low transaction costs, and corrections of mar-

ket failures resulting from state ownership and family-owned banks. Such an efficient market with symmetric transfer of information can be promoted if there are good legal and accounting systems that protect individual property rights, enforce contracts and provide for due process. A good market should also regulate for market failures to prevent socially costly bank runs and crises. Meanwhile, both the internal and external stability of the macro economy should be ensured to allow business and investment to flourish.

The market failures and moral hazard regime in many emerging economies have diminished slightly with the end of financial repression, and the corporatization of state-owned financial institutions and improvements in regulatory systems. Meanwhile, stricter enforcement of legal lending limit regulations reduces the old practices of family-owned private banks mainly lending to themselves and their affiliated business ventures. Moreover, the newly established deposit insurance companies have replaced the blanket guarantee on bank deposits by limiting recoverable amounts. There is still a general perception, however, that state-banks will not go bankrupt as the government will always bail out its own banks if short-term liquidity is needed.

The governments of many emerging economies own more than one bank. It was a popular idea in the 1960s to establish state-owned development banks that would raise long-term savings, including through bonds, for financing long-term development projects. In reality, none of these development banks have raised long-term savings and all of them operate like deposit-taking commercial banks, also providing short-term commercial loans. In many countries, such as Indonesia and Brazil, both central and provincial governments have their own deposit-taking development banks, and many lower layers of government own rural credit institutions that compete with money-lenders. State-owned banks in many emerging economies in Asia, with the exception of Singapore, are well protected and as a group enjoy a monopoly over public sector deposits.

During the long period of past financial repression, state-owned banks owned by the central government aimed their lending programs based on low interest rates and low risks at advancing government industrial policy. These banks frequently had to provide a large volume of loans to non-bank state-owned enterprises operating under

soft-budget constraints. The central banks provided liquidity credit for financing the credit programs either through expansion of their balance sheets or from foreign borrowings. Banks owned by provincial governments acted as cashiers for their owners and mainly provided loans to local government employees backed up by their pay checks. Through such operations, the state-owned banks were acting as quasi-fiscal agents and were insulated from systemic risks.

Weak commercial orientation and limited risk management discipline for self-protection eliminated the incentive for managers of state-owned banks to monitor and manage risks, upgrade transparency in corporate reporting or provide relevant business information. Both the channeling banks and supervisors were more interested in checking that credit delivery was in accordance with the intended purposes. As credit was allocated based on a non-interest basis, and not always on economic considerations, supervisors classified loans based on repayment, rather than the creditworthiness of borrowers or the market value of the pledged collateral. Such inefficient, non-price allocation of financial resources resulted in poor asset quality and high levels of non-performing loans. Bank supervisory officers at that time received little training in the field of credit analysis and risk management in banking sector organizations.

Traditionally, every business conglomerate in East and Southeast Asia owned at least one interconnected family bank. Prior to the AFC of 1997, the main role of such banks was to mobilize funds from the general public, to obtain low cost and risk free refinancing from the central bank, and to secure overseas borrowings for meet the financial needs of its commercial affiliates or subsidiaries. Non-arm's length transactions between banks and their affiliates were rarely detected and corrected by bank supervisors. The banks also provided credits to small and medium enterprises that were closely linked, such as suppliers and distributors. Affiliated banks supplied consumer loans and mortgages to buy motor vehicles, appliances or real estate from group companies.

Such practices improve credit efficiency as bankers have more information on affiliates compared with non-affiliates. Banks can also use internal information to assess the ex-ante risk of investment projects or persuade the borrowers to cancel risky projects. On the other

hand, related lending is prone to insider trading and principal-agent problems as banks tend to evaluate loan applications from affiliates less rigorously than would be the case with unaffiliated credit applications. The practice of giving preference to affiliated companies ended with the collapse of family-owned banks during the AFC and stricter implementation of tight prudential rules and regulations after the crisis. The legal lending limit rules restricted bank exposure to affiliates, including owners, managers and employees. Interest rate costs were expected to increase and return on bank equity to decline because of a combination of an increase in the (i) common capital requirement, (ii) conservative buffer, and (iii) countercyclical capital buffer.

The transfer of bank ownership from conglomerates to foreign investors during the crisis years in 1997-1998 significantly reduced the share of lending going to business affiliates. The new owners increased the share of credit going to small and medium enterprises, as well as consumer credit to the household sector. To reach out to these classes of customers, the foreign banks introduced modern payment systems such as credit cards, debit cards, ATMs and e-banking.

A number of factors have deterred the development of the capital and corporate bond markets in this region. Firstly, bank dominance and the availability of cheap and low risk credit from state-owned banks during the long period of past financial repression. Secondly, close family owned companies do not like to share ownership with outsiders. Thirdly, the small size of companies makes raising funds through the capital and bond markets more expensive than bank financing. To save on the regulatory costs of public listing, those companies that resort to bond financing prefer private placements with a small number of investors. Fourthly, legal uncertainties and weak institutions, particularly in regards to due process, the insolvency process, creditors' rights and investor protection deter the development of these markets. Foreign owned firms rely on retained earnings and internal funding from their parent corporations, while state enterprises rely on capital injections from the government.

The high cost of intermediation is clearly shown by high banking spreads or net interest margins (NIM) that result from poor market infrastructure, including legal and accounting systems. The poor legal and accounting systems give rise to lower recovery rates and longer

times to gain possession of loan collateral. High bank interest rates give rise to a competitive challenge for the banks from the bond and capital markets. At present, the bonds traded on the market are mainly the sovereign bonds issued in 1997 to recapitalize financially distressed banks and to finance government budget deficits. To supplement the small amounts of short-term Treasury bills, the Central Banks of Thailand, Indonesia, China and Korea issue interest bearing bills as instruments for open-market operations.

The issuance of sovereign bonds in many countries in East and Southeast Asia started in 1998 for the purpose of recapitalizing financially distressed banks during the 1997 AFC and for the financing of government budget deficits after the crisis. Particularly during the Cold War, public budget deficits in some countries in this region were financed by official development aid based on long-term maturities and low interest rates. To avoid foreign exchange risks, most of the government bonds are denominated in local currencies.

On the demand side, institutional investors, such as insurance companies and pension funds are not yet developed in these emerging countries. Of all the countries in this region, only Japan and Taiwan have Postal Savings Banks that mobilize domestic savings from the general public at low cost. As a result, a large share of the sovereign bonds in many countries is absorbed by short-term foreign investors. As shown by the experiences of the countries on the periphery of the European Union, large short-term capital inflows to absorb sovereign bonds denominated in local currencies have eroded their external competitiveness and made their economies sensitive to capital flow reversals.

Table 2. Size and Composition of Financial Systems in Asia (% of GDP)

Country	Financial Sector Assets ¹				Market Capi- talization ²		Total Bonds Outstanding	
	Deposit-taking Financial Institutions		Non-bank Financial Institutions					
	2000	2008	2000	2008	2000	2008	2000	2008
China	168.8	204.5	8.8	33.9	27.1	32.3	16.9	50.3
Hong Kong	505.5	640.7	196.4	573.8	363.9	610.9	35.8	42.9
India ³	61.6	91.6	15.4	32.8	33.3	59.7	24.6	35.3
Indonesia	63.6	48.6	8.8	13.7	18.7	21.7	31.9	13.4
Korea	147.9	192.7	44.1	62.6	31.2	56.3	66.5	86.2
Malaysia	154.2	190.3	16.5	20.2	124.7	89.6	74.8	73.5
Philippines	99.2	78.8	22.4	18.5	76.8	54.3	27.6	33.7
Singapore	683.8	707.9	39.1	47.1	243.7	148.0	48.0	70.8
Taipei, China	259.9	289.6	29.8	80.6	81.7	94.7	7.7	7.7
Thailand	132.3	137.7	10.7	33.0	26.0	39.2	25.3	51.6
Average ⁴	227.7	258.2	39.2	91.6	102.7	120.7	35.9	46.5
Median	151.1	191.5	19.5	33.4	55.1	58.0	29.8	46.6
Eurozone	230.0	315.8	142.1	169.3	-	-	124.2	69.4
Japan	227.5	230.9	118.5	132.1	71.7	55.8	97.4	193.4
United States	78.3	104.8	283.2	306.1	117.5	64.6	41.8	55.3

Notes:

Financial asset data for People’s Rep of China (PRC) for 2002 and 2007; Hong Kong, China, for 2000 and 2007; Indonesia for 2001 and 2007; Malaysia for 2000 and 2007; and Japan for 2001 and 2004.

Market capitalization as percentage of gross domestic product (GDP) in local currency.

Financial sector assets data for India in 2000 refers to FY ending March 2000; and for 2008 ending March 2008.

Simple average

Source: Chee Sung Lee and Cyn-Young Park. 2009. *Beyond the Crisis: Financial Regulatory Reform in Emerging Asia*. ADB Working Paper Series on Regional Economic Integration No.34. September, Table 1 Page 12.

The booking of government bonds from regional financial centers is also encouraged by tax treatment. Indonesia, for example, withholds 20 percent on both yield and capital gains from investment in debt se-

curities and *sukuk*, Islamic shariah based bonds. But there is a tax treaty between Indonesia and Singapore for exempting withholding tax for non-resident investors that hold Indonesian bonds via Singapore.

Conclusion

Basel III was mainly designed to meet the needs of the financial systems of advanced industrialized economies. It fails to address the needs of emerging economies that increasingly occupy a prominent role in global finance. Basel III mainly focuses on regulating capital, liquidity, transparency and integrity of financial institutions in mature and well developed financial markets, including bond and capital markets as well as those for sophisticated derivatives and complex securitizations. In such mature markets, individual private property rights are well defined and protected. Contracts can be enforced promptly at low cost, and market failures can be corrected to prevent socially costly bank runs and crises.

By contrast, the legal and accounting systems need to be strengthened in emerging economies to protect individual property rights, reduce transaction costs and minimize market asymmetries. Weak legal systems fail to enforce contracts and ensure that realization of collateral pledged by credit defaulters. A case in Indonesia in May 2011 indicates that the legal system is unreliable even when it involves the use of debt collectors by Citibank to lynch one of its credit-card defaulters on Citibank premises. The disinclination of bank supervisors to enforce rules and regulations raises transaction costs.

Basel III's regulations of complex securitization exposures, such as collateralized debt obligations (CDO), are irrelevant to the emerging economies. This is because the shadow banking system, which includes finance companies, hedge funds and investment banks, is still in the early stages of development in these countries. The banking system remains the core of the financial system in emerging economies. Bank operations are mainly concentrated on traditional deposit taking and lending and less concerned with the capital and bond markets. Domestic financial institutions use few financial innovations such as structured products, derivatives and complex securitizations.

Moral hazard is still prevalent in the emerging economies. Except in Singapore, the roles of state-owned banks and financial institutions

are still dominant in many emerging economies. Even in banks that have been privatized, the government continues to hold golden shares. The management and operation of the state-owned banks are still regulated by their owners who use them to pursue their industrial policies. It is generally perceived that the government will stand by their banks and bail them out if short-term liquidity is needed. Deposit insurance companies, however, have been established in many countries to replace blanket insurance with limited guarantees.

The transfer of ownership of domestic private banks to foreign investors has improved their operation from being traditionally intertwined with their business affiliates to a broader customer base. Greater penetration of foreign banks in domestic markets and a gradual increase in the importance of the bond and capital markets have introduced greater competitive pressures into the banking system.

For a number of reasons, credit rating and credit scoring systems and stress testing that demand reliable, up-to-date and comprehensive information are either not yet in existence or are meaningless in the emerging economies. This is because of the limited availability of data and information systems which are due in part to the weaknesses in the legal and accounting systems, limited access to information, and the availability of implicit guarantees from government.

Global Power Shift and Asia¹

*Jusuf Wanandi*²

Economic development in East Asia started 40 years ago when Japan's economy developed quickly, and gave to others an example to follow through the so-called "flying geese" pattern. The Asia's "young dragons" such as South Korea, Taiwan, Hong Kong and Singapore followed suit and later the example began being emulated by ASEAN's members like Thailand, Malaysia, Indonesia, and the Philippines.

At the end of the 70s China changed her strategy of development under Deng Xiaoping, giving a big boost to East Asia's economy, and was followed by India in the beginning of the 90s. China was not the only locomotive of East Asia's economy rise, but vast size of her economy that gave made the impact so apparent. That is why we can talk now about the center of gravity of the world economy moving towards East Asia. Furthermore, following the financial crisis of 2008/2009 the trend or reorientation towards East Asia has become more permanent.

The Chinese economy has now become the center of East Asian economy, because of the demography that has defined the size of the Chinese economy for our region and the world, and also due to the increase of productivity, thanks to investments in education and R & D. Since East Asia has become an enormous economy, the importance of the region has also increased. Whilst in the previous decades the US defined the politics and security of East Asia, the future of the region's strategic development will be much more complex.

¹ Paper presented at the International Symposium on "Global Power Shift and Asia" hosted by the Seoul Forum for International Affairs (SFIA) to commemorate its 25th anniversary. Westin Chosun Hotel November 29, 2011, Seoul – Korea.

² Jusuf Wanandi is the Vice Chair, Board of Trustees, CSIS Foundation.

At one stage 40 years ago, Japan and China (when China opened up to the US in 1972) were willing to give the dominant role to the U.S. in East Asia but now not one country can maintain peace, stability and development on their own in East Asia. While the U.S. is still a global power, and the military might is still the greatest, the country alone can no longer keep the East Asian regional order alone. The U.S. needs her allies and friends to do it together.

Before the financial crisis of 2008, it was expected that President Obama, who understood strategic developments of the world, East Asia and the U.S.'s own capabilities, could lead the U.S. to implement a strategic adjustment for U.S. policies towards East Asia. However, the crisis and the pressures on the U.S. economy, plus the results of the midterm elections of November 2010 where the Republicans won the majority at the House of Representatives, made the move to lead for change almost impossible. In fact, the weaknesses of the U.S. economy, and the influence of the extreme wing of the Republican Party (the Tea Party) on the U.S. economic, weakened the position and popularity of President Obama.

Lucky for East Asia, bipartisan support to maintain a strategic U.S. presence, in the Western Pacific, made possible through alliances and the forward deployment of the Seventh Fleet, has been there since WW II.

President Obama started with the so-called Obama doctrine (Hugh White) to put Asia Pacific as U.S main strategic focus. This effort was received with mixed feelings in the region, because the cuts of the U.S. defense budget will put some real constraints on the USA, despite assurances from President Obama. And the ways it was to be implemented, mainly based on military power, might miss the real concerns of the region, which are more complicated. In fact, the main concern in the region is that the military status quo is starting to become more uncertain due to an increase of defense capabilities in the region, and the inadequacies of instruments to deal with these developments. So, U.S. increases of military might only increase the complexities of the strategic problems. Furthermore, it might prove to be divisive for the region, because it may be seen as a move to contain China and by doing so it will create pro and contra among the members of ASEAN.

China, who likes to accept a certain role for the US in the region, is now asking what the U.S. role should be for the region's future. While China seems to like having the U.S. presence in East Asia, she recently stressed that the U.S. role should be more multilateral in the future, and if China's national interest is at stake she will become more assertive. That will be acceptable if done peacefully and transparent, through diplomatic instruments and dialogues. China should not repeat its "revolutionary" or "cultural revolution" ways. China is now big and developing very fast and, therefore, it does not need the old ways and methods that were used when it was still feeble and not recognized internationally as nowadays in relation to her policies and activities. "Soft power" or "smart power" is the way for China to move in the future. That will not be always easy, because among her populace especially the youth, a certain pride of what China has achieved in the meantime could give some pressures to the government to be more assertive in its foreign policy.

Chinese policies in 2010 on the Korean Peninsula, and on its claims on the East China Sea and the South China Sea have created reactions from countries in the region that are not conducive to China's own national interest in peace and stability in the region. Even when China has the military capacity to face the US in defending her coastal areas in an asymmetric strategy (against U.S. dominations in the Western Pacific), her economic development still needs peace and stability in the region. Conflict or confrontation will be against her efforts to develop economically and modernize.

It is heartening to note that China in 2011 has changed her "strong policies" with an initiative to talk bilaterally to South Korea and the U.S., and proposed to have another series of Six-party Talks on the nuclear weapons of North Korea, after the corvette Cheonan and the shelling of the Yeonpyong Island incidents by the North, which brought a tightening of policies between ROK, Japan and the U.S. towards North Korea. But the other parties of the Six-party Talks were non-committal, because they thought China's reaction was too little and too late, although the proposal were not rejected outright. Because of that China should take up new efforts to win the trust of the region again. It might take some time for her to learn how to react, because it was only 30 years ago that China had been exposed to the outside world.

China's willingness to prepare a Code of Conduct on the South China Sea based on the Declaration of Conduct with ASEAN has shown a willingness to work with ASEAN to find a way out to calm down the South China Sea overlapping claims. In so doing she recovered some of her credibility in the eyes of ASEAN.

There are two things that merit our attention as to avoid misunderstanding. Firstly, ASEAN as a group is not party in the claims and counterclaims in the South China Sea disputes. The claimants states are some members of ASEAN, namely Brunei, Malaysia, Philippines and Vietnam, and so are China and Taiwan. Therefore, ASEAN does not support or oppose the claims of the four ASEAN member states, and it also does not take any position on the merits of the disputes between China and ASEAN claimant states. ASEAN is, however, a stakeholder in the South China Sea: it wishes to maintain peace in the region, to promote good relations between ASEAN and China, it is committed to peaceful settlement of disputes, and wishes to ensure that all parties act strictly in accordance with international law, especially UNCLOS³.

Secondly, the wishes of ASEAN to finalize a Code of Conduct as a legal instrument for any disputes in the near future is not an effort to gang up against China and her claims, or supporting the claims of ASEAN member states, but instead to install a regional order or a legal framework in the South China Sea for keeping order, preventing conflicts from arising and escalating, managing disputes, building regional confidence, sustainably manage the South China Sea as a semi-enclosed sea under UNCLOS. The purpose is to create a peaceful environment for the eventual resolutions of disputes. Therefore, the effort of establishing the Code of Conduct should be agreed upon without prejudice to any territorial or jurisdictional claims of the Parties in the South China Sea.

It is a fact that efforts to formulate a Code of Conduct, as agreed upon by ASEAN and China, will take some time to finalize. That is why simultaneously the DOC (Declaration of Conduct of Parties in the South China Sea) which has some principles, proposed CBMs and other cooperative activities should also be negotiated for implementation, and in so doing create a conducive atmosphere to support the negotiations on the COC.

³ Tommy Koh, *The Straits Times*, September 13, 2011

Some principles in the DOC which have been agreed upon by ASEAN and China are important to keep peace and order in the South China Sea and could be adhered to voluntarily until a more legal binding Code of Conduct can be finalized and implemented.

These principles are:

- Commitment to international law including the UN Charters, the 1982 UNCLOS, the TAC, Five Principles of Peaceful Co-existence as the basic norms governing the relations between the two parties;
- Committed to exploring ways for building trust and confidence in accordance with the above principles on the basis of equality and mutual respect;
- The Parties re-affirm their respect and commitment to the freedom of navigation in and over flight above the South China Sea as provided for by the universally recognized principles of international law, including the 1982 UNCLOS.
- The Parties concerned undertaken to resolve their territorial and jurisdictional disputes by peaceful means, without resorting to the threat or use of force, through friendly consultations and negotiations by sovereign states directly concerned, in accordance with universally recognized principles of international law, including the 1982 UNCLOS.

The Parties undertake to exercise self-restraint in the conduct of activities that would complicate or escalate disputes and affect peace and stability including among others, refraining from inhabiting the presently uninhabited islands, reefs, shoals, cays and other features and to handle their differences in a constructive manner.

CBMs mentioned in the DOC to be undertaken are:

- Holding dialogues and exchange of views as appropriate between their defense and military officials;
- Ensuring just and humane treatment of all persons who are either in danger or in distress;
- Notifying, on a voluntary basis, other Parties concerned of any upending joint/ combined military exercise, and
- Enhancing, on a voluntary basis, relevant information.

While some of the cooperation activities to do, explore or undertaken are among others:

- Marine environmental protection;
- Marine scientific research;
- Safety navigation and communication at sea;
- Search and rescue operation; and
- Combating transnational crime, including but not limited to trafficking in illicit drugs, piracy and armed robbery at sea and, illegal traffic in arms.

It is in Northeast Asia where the big powers are facing each other and where their relations will be defining state of affairs in the whole region: China, U.S.A., Japan and Russia. It is also a region where "realist" policies are defining peace and stability, and balance of power has an important meaning; and where defense spending are high and an arms race can become a real problem if nothing is done soon in time. It is also a region where there are remnants of the Cold War, mainly the divided Korean Peninsula and the unresolved issue of Taiwan.

Last but not least, it is also a region where nuclear proliferation has raised its ugly head with North Korea developing nuclear weapons that have the potential to radically destabilize the region, because three other economies in that region are also capable of revoking the nuclear weapons threshold if a political will to do so exists. If the North Korean proliferation continues and if there is no stability and peace in sight, then a drive to go nuclear may be inevitable.

Simply put, the North Korean nuclear proliferation has the potential to become the most explosive issue in East Asia as a clear and present danger of a nuclear confrontation.

It is critical for the entire region that ASEAN and others in East Asia, such as Australia and New Zealand, get more involved and supportive of the peaceful developments on the Korean Peninsula. Indonesia had sent a presidential envoy to North Korea since Megawati's presidency to encourage Kim Jong Il to find a solution to the proliferation problem. She used her father's (Soekarno) close relations with the late Kim Il Sung as the basis of her personal diplomacy. While it is

unclear what the immediate results have been, it should be regarded as a positive effort to show that the region is concerned about the issue and that not all countries have been against North Korea in all aspects of the problem. Another case in point is that ASEAN, at Indonesia's initiative, encouraged the two Koreas to talk again during the last ARF meeting in Bali in July 2011, which also opened a chance for the U.S. to talk to the DPRK representative directly, which had been done twice.

In addition the new East Asian Summit (EAS) with the U.S. and Russia as members will be another forum where strategic issues such as the Korean Peninsula nuclear proliferation should be discussed. The problem has a long history and many misjudgments and mistakes have been made by the two Koreas in their search of solution, and also by China and the U.S. and to a lesser extent by Japan and Russia.

It is obvious to me that the problem of proliferation on the Korean Peninsula emerged when the DPRK, for whatever reason, be that for self defense against U.S. threat or attack, was clandestinely producing nuclear bombs, both uranium and plutonium based, and missiles as well.

This is considered an illegal act and should be prevented from continuing. Otherwise the DPRK can get away with anything against the ROK through the threat of nuclear weapons that in turn will create a threat to peace and stability in East Asia. Containment should be part of the policy, but with a flexibility to implement it through diplomacy, through bilateral and multilateral efforts of the ROK and the U.S. with DPRK, and through the Six-Party Talks when North Korea is ready for this under the leadership of China.

For this approach to be effective, the cooperation among the U.S., Japan and South Korea has to be stonger than ever before and be prepared to work with China which should not just consider DPRK as its ally, which is fair, but also the future of East Asia, and its own prestige in the region as a big and important country.

This proliferation also could not be tolerated because it could be considered as the beginning of proliferation of nuclear weapons in Northeast Asia, where Japan and South Korea could also proliferate if they think that the extended deterrence from the US could no longer protect them in the future.

Another important problem that may arise is whether the U.S. will show restraint if China would like to assert her interest in another “strong” way in the future. More importantly is whether the U.S. is willing to accept China as an equal in the longer term. This cannot be easily discerned or projected now because of the so many opinions in the U.S. that has not been consolidated into a majority opinion. The Obama “doctrine” however might move it into a majority policy. That is why how the doctrine is going to be formulated and especially implemented, is important to the region and also to U.S. interest in the long-term in East Asia. A lot more of consultations with ASEAN are really needed about their expectations of U.S. presence in the future. Besides, it should also be recognized that the US has an interest to get China’s cooperation in many fields, such as on US economic development, to get rid of nuclear weapons of North Korea and Iran, the problem of the environment and climate change, and other common issues, such as pandemics, food and energy security among others.

Basically the relationship between China and the U.S. is partly cooperation and partly competition. So, while it is not expected that a war or major a conflict take place between them in the foreseeable future, the development of the relationship finds itself now at a cross-road. While on the one hand China has given the primary role to the U.S. since 1972 in East Asia, partly because of a common threat in the form of a USSR, it would also like to concentrate on its own development, that could no more be so automatic in the future. Not only China has developed her economy so remarkably, its younger generation is also becoming more assertive and may stand up against a “hegemonic” U.S. in the future. But the government realizes that China is not in state to allow this to happen, as above all it needs peace and stable environment to be able to develop and modernize further. While a lot has been achieved, China’s per capita income is still less than 1/10 of the U.S. and the income discrepancy in the country has not been solved. Meanwhile, problems of pollution, water scarcity, demography and the need for political development including the economic restructuring are all gigantic problems.

The latest trend is that the U.S. is returning its attention to Asia Pacific, because its involvements in the Middle East, Iraq and Afghanistan are becoming less heavy and it understands that the Asia Pacific, espe-

cially East Asia, is going to be the most important economies not only globally, but also to get the U.S. economy grow again. For East Asia, the U.S. economic restoration is the most important factor to guarantee that it can become the unalienable part of East Asia. Reforms in US education, infra-structure, and R and D will be critical for its recovery. While the presidential election of 2012 is still very uncertain, there is in fact a bi-partisan support for U.S. policies towards East Asia, although a new president after Mr. Obama could be more inward looking or more inclined to take a confrontational approach towards China. Therefore, while there will be no war between the two great powers in the foreseeable future, tensions and some political confrontation may erupt. And since 2012 is an election year, rhetoric and perceptions created could be very negative and dangerous for future relations between the two big powers and should be watched by both sides, because the economic malaise in the U.S. could exacerbate Americans reactions to the campaign towards China, and could be more damaging for future relations than earlier elections campaigns.

And it should be kept in mind that power is not only going to depend on military might or economic prowess, but also on other aspects of "smart power", such as intellectual capabilities, ideas and tradition of leading the region and the world. Here the U.S. is still the most powerful nation. And we in East Asia should be able to learn from it, since we also will be considered as the next influential nations for the future.

Therefore, a regional concert of power in East Asia can serve as an important instrument to alleviate those dangers, which would only hamper economic development and create more uncertainties for the future. Hopefully the East Asian Summit would be able to play much an important role accordingly in the future. Several possibilities in the future relations between China and the U.S.:

- To have a duopoly of a G-2 type of relationship which divides the world and East Asia between the two of them. At one time, there was a worry that it might happen when the two teams of ministers were meeting twice a year. The first U.S. team was led by Hank Paulson as Secretary of Finance under President George W. Bush, and later a team led by Secretary of State Hillary Clinton and Secretary of Finance Timothy Geithner under

President Obama. Apparently, there are too many differences in values, ideologies and interests between the two to be able to agree on basic principles to share power between them at this stage of development.

- The existing worries now is more on the probability that the U.S. and China will oppose or confront each other in many fields that will destabilize not only East Asia, but also the world at large. It could become a U.S. containment imposed upon China. But here the size of China will make that impossible, and China is a “reforming” status quo power, who has no intention to replace the international order as the USSR way trying to do earlier.

And, those worries are seemingly more exaggerated because there are also many areas of cooperation, where both China and the U.S. have a stake to cooperate in search of solutions, such as in global economic development, on environment and climate change, energy security, and many other global commons such as pandemics, freedom of navigation, and security issues such as non-proliferation of WMD, terrorism and maritime security. A containment policy may also not be successful especially when countries in East Asia are unwilling to take sides but rather would be neutral. The U.S., however, may need to keep pushing China to take responsibility as a big power, which is not natural for a nation which has just recently accended to be such a big power in the region and the world. As far as the U.S reactions are to China and developments in East Asia, it should be recognized by the U.S. that the strategic situation and development of the region has made it impossible for the U.S to have the same “hegemonic” position as 10 years ago, where she mainly paid attention to the Middle East. It should be more multilateral in its approaches towards, its friends and allies, and using mainly “smart power”.

At the end, the question which arises is whether the U.S. is willing to accept the idea of China as an equal in the next 20-30 years, and to recognize that there are limits to her “exceptionalism” that has been ingrained in her psyche throughout history. Therefore, the East Asian summit as a concert of power in East Asia will be very relevant and critically important in facing the uncertain future in the region. If EAS

can thrive and ASEAN's catalyst role can be maintained, there is a possibility that it will work. The first EAS Meeting in Bali on November 19, 2011 attended for the first time by U.S.A. and Russia has put some principles and agenda together, was only a beginning and it should be supported in the future by all members.

The East Asian region, including ASEAN and Indonesia, has an interest to have a stable relationship between the two great powers. That is why we in the region have to watch the strategic development of East Asia very closely. Because, even if economic power cannot be translated immediately into political power, it is going to happen soon enough by looking at the pace of the economic development of China, when China's GDP can become the biggest economy in the world within 20 years, although China does has a longer way to go to have the same level of GDP per capita as the U.S.

When China's defense budget increased every year in double digits for the last 15 years (except for 2010), it can be expected that after 10 more years of such an increase, her military power can create a certain balance with the U.S. in East Asia, especially if she is preparing for an a-symmetric warfare against the U.S. Because of the change in future balance of power, East Asia has to ensure it does not experience the same tragedy as Europe did at the end of the 19th century, which brought about World War I, the rise of extreme ideologies (Fascism/ Nazism and Communism), World War II, and the Cold War, which only ended in 1989 with the collapse of the Berlin Wall and the breakup of the USSR.

As a result of those developments, Western Europe after the World War II worked hard to integrate deeply and widely, until finally the EU was formed with 27 members, to prevent another great conflict in the future. The financial crisis faced by the Euro-zone ,however, raised a question mark as to whether or not the Euro can be maintained, and whether the EU itself can be survive without the euro, after two years of half-hearted Euro-zone policies towards the problems of sovereign debts and the banking liquidity in Europe.

East Asia is aware that such tragedy and challenges can also happen in the region. That is why there is a need to establish East Asian regional institutions to assist bilateral relations between the U.S. and China stable. Among others, ASEAN managed to craft a new East

Asian Summit, which includes the U.S. and Russia as a culmination of East Asian regional institution building for the last two decades.

Hugh White, a well-known strategist from the Australian National University, stated that the EAS should try very hard to become a "concert of powers" of East Asia, which can establish regional order in the region.

Although not all rules on the EAS have been concluded, Indonesia's ASEAN chairmanship has put it in a very important position at the Leaders Summit in November 2011 dealing in strategic issues: political, economic and security, to define the future of East Asia through a "concert of powers". Indonesia's support for the EAS to be able to play its role is critical, because of its leadership in ASEAN, so is great powers support, especially U.S. and China.

The implementation of EAS decisions can be realized by existing regional institutions, e.g. the non-traditional security by the ASEAN Regional Forum (ARF), the traditional security by ASEAN Defense Ministers' Meeting + US, Russia, China, South Korea, India, Japan and Australia, New Zealand (or ADMM Plus), and the functional cooperation including economic cooperation by the ASEAN Plus Three (APT). To be effective the ADMM Plus should be held annually rather than every two years, and the APT should be open for other member(s) of the EAS as needed.

All the decisions at the EAS could become an input for the APEC Summit and for the G20 process, since East Asian's contribution as the main economic power for global economic development is important.

The question that arises is whether ASEAN can deliver since it is often seen as a place of 'shop-talk' rather than an action-oriented institution. To establish an EAS with such a role for the region needs a credible and authoritative regional institution for its underpinning.

Indeed ASEAN should strengthen itself by amending its Charter to be more integrated, able to take the necessary decisions to become an effective interlocutor for EAS. For that purpose a majority rule should be accepted, the Secretary General should have more authority, the availability of deeper budget is a pre-requisite and it should have more popular support among its own citizens.

But great powers, especially U.S. and China should also be supportive of ASEAN's role in making the EAS working in the future, be-

cause there are no alternatives in the near future. U.S. initiatives to increase its role in East Asia particularly should not divide ASEAN's unity. For that a lot more consultations on those policies need to take place between the U.S. and ASEAN as a whole. And keeping the bilateral relations with China on an even keel is critical. For that matter, it should be understood that the Trans Pacific Partnership proposal of President Obama is also going to divide ASEAN, because some of ASEAN members including Indonesia could not participate in the proposal, because they are not ready. This will result in APEC, after 30 years of cooperation being left behind.

To have a critical mass ASEAN should cooperate within East Asia with the ROK and Australia as middle level powers to move it forward.

Trans-Pacific Partnership Initiative: An Indonesian Perspective^{1*}

Jusuf Wanandi and Raymond Atje²

Introduction

The idea of a Trans Pacific Partnership (TPP) trade deal has generated a lot of expectations since the Obama administration announced that the United States (US) would join the trade bloc. The trade bloc initially known as the Pacific-4 (P-4) and consisted of four relatively small Asia Pacific countries—Singapore, New Zealand, Chile and Brunei Darussalam. The members of the P-4 envisaged a comprehensive trade agreement, covering all goods and services, hoping it would eventually lead the creation of a trans-Pacific free trade zone.

The P-4 was established during a period of rapid proliferation of free trade areas (FTA) involving Asian countries in the Asia-Pacific region. This proliferation followed the rapid economic growth experienced by Asian countries. The rapid economic growth has been sustained by two different sets of policies: unilateral liberalization and export-oriented policies. Initially, Asian countries seemed to shun regional trade arrangement and preferred multilateral trade arrangement instead. However, once they began to embrace the idea, the number of FTAs involving Asian countries increased rapidly (Table 1).

From the perspective of Asian countries, their involvement in FTAs may be seen as an attempt to preserve at least the spirit of the two policies mentioned earlier. These two policies underline the im-

¹ Prepared for CNCPEC International Seminar on Trans-Pacific Partnership in Asia Pacific Regional Integration, Beijing, December 8 – 9, 2011

² Jusuf Wanandi is the Vice Chair, Board of Trustees, CSIS Foundation and Raymond Atje was Head of Department of Economics, CSIS.

portance of trade as a vehicle to maintain rapid economic growth. This time they want to ensure markets for their products and also resources for their industries through FTAs. While in theory trade between any two countries will be beneficial for both, in reality, from a particular country's perspective trade benefits vary from one trading partner to another. Through an FTA a country can choose its preferred trading partner or partners. In trade, there are countries that, for economic as well as political reasons, other countries cannot ignore, at least not for too long. China and the United States (US) are two of them.

It has been argued that FTAs in East Asia are essentially politically driven (Soesastro, 2003). As an example Soesastro points to the attempt to establish a Japan-Korea FTA in the late 1990s. It was meant to solidify the two countries' political relationship. But the attempt ran aground for an economic reason: the economic benefits from the FTA were perceived as too asymmetrical to the Koreans disadvantage.

But, it may also be argued that political consideration played an important role in the abandonment of the Japan-Korea FTA proposal as well. An FTA must also be politically viable, as it requires support from domestic stakeholders (Grossman and Helpman, 1995). Quite often a country fails to consult domestic stakeholders before forming an FTA only to face domestic opposition afterwards. As a case in point, after the ASEAN-China FTA entered into force, some industries in Indonesia requested the government to renegotiate some of the terms in the agreement that they considered as having adverse effects on them. Apparently the Indonesian government failed to consult the private sector during the negotiation process.

One may argue that the creation of the P-4 was also politically motivated. As Soesastro (2003) notes, Singapore, one of the founders of the P-4 'sees the need to differentiate itself from the rest and to remain in the radar screen of its major trading partners by going into bilateral FTAs.' Similarly, the American administration wants to use TPP as a platform to engage the Asia Pacific region in general, and Asia in particular. Initially, nine countries have signed up to join the TPP initiative, namely, Australia, Brunei, Chile, Malaysia, New Zealand, Peru, Singapore, the United States and Vietnam. More recently, during the APEC Summit in Honolulu, three additional countries, Canada, Japan and Mexico, have expressed their interest in joining the initiative.

Meanwhile, Indonesia has declined to join on the grounds that it is not yet ready. As will be discussed further later, it is unlikely that a decision to join the TPP will gain domestic support at the moment. A closer look at the problems confronting Indonesia reveals that some of them, such as lack of infrastructure, can be resolved only over a relatively long period and in a gradual manner. Many of these problems are typical of developing countries and they affect its economic competitiveness. This paper argues that richer economies are more likely to join the TPP than developing ones. There is a risk therefore that the TPP may unintentionally preserve the rich-poor dichotomy among countries in the region.

The rapid economic growth in East Asia noted earlier has led to a shift in the concentration of economic activities from the North Atlantic region toward the Asia Pacific region. In a relatively short period, China's economy has become the second largest in the world, second only to that of the US. Just recently China surpassed Germany as the largest exporter in the world. It is perhaps inevitable, if unintended, that the rapid rise of China would lead to its rivalry with the US. This paper also argues that the China-US rivalry would influence, for better or worse, the dynamic of the formation of regionalisms in the Pacific region. There is a danger that the rivalry would stymie efforts to establish an East Asian community. The inability of countries in the region to choose between ASEAN Plus Three, ASEAN Plus Six and ASEAN Plus One as the platform for launching East Asian regionalism in an unfortunate sign of this. But the region cannot afford to let its future get tangled in the rivalry of the big powers. There is a hopeful sign that a recent development with the TPP could lead to a closer relation between China and Japan; however, it is reported that in addition to joining the TPP, Japan would offer to negotiate an FTA with China at the same time. If this indeed is the case, it could provide East Asian countries with an opportunity to decide once and for all on the regional architecture that would become the basis for an East Asian community.

Global Economic Shift and the Rise of Asia

The geography of economic activities has undergone rapid change in the last three decades. It used to concentrate primarily in the North Atlantic regions, i.e., North America and Western Europe. But in recent

years more regions began to emerge as centers of economic activities albeit with varying size and degree of intensity. The most prominent of them is Asia. The region's share in the global economic output has experienced a noticeable increase during the period under consideration. In 2010 the region's gross domestic product (GDP), in purchasing power parity (PPP), accounted for around 30.6% of the world GDP, up from 20.4% in 1990 (Figure 1).

The rise of Asia has been a gradual process and has picked up pace only since early 1980s. There are a number of factors that explain the rise of Asia. Firstly, since 1970s, or perhaps somewhat earlier, successive governments in the region began to undertake unilateral liberalization and open up their economies in part to attract foreign direct investment (FDI) so as to create jobs (Baldwin, 2006). For those countries unilateral economic liberalization was part of their economic development strategy. The opening up of China in 1978 was a watershed moment that has helped propelled the region's economic ascent; since then China's economy has been growing by leaps and bounds. In 1990 China's GDP (PPP) accounted only around 3.6% of the world GDP but by 2010 the number has reached 13.2%. India's economic liberalization in the early 1990s has also let the country's rapid economic growth, albeit somewhat less spectacular than that of China.

Secondly, in addition to unilateral liberalization, most countries in the region also adopted export-led growth policies. This is essentially a policy to speed up the process of industrialization through the promotion of exports. Export-led growth might necessitate the opening of certain domestic markets to foreign competition in exchange for market access in other countries. As a result the region experienced a spectacular export growth, from \$419.4 billion in 1990 to \$3.4 trillion in 2008. Similarly, the region's trade-to-GDP ratio rose from 67.8% in 1990 to over 90% in 2008 and its export-to-GDP ratio reached 47.6% in 2008 (Kim et al., 2010).³ The region's rapidly growing trade reflects its dominant position in global manufacturing, which is the result of a combination of low wages, increasingly educated labor forces, sophisticated technologies, high productivity growth, large markets and,

³ East Asia includes China, Hong Kong (China), Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand.

above all, the ability to bundle together diverse production advantages (ADB, 2008).

Thirdly, beginning in 1970s, companies from Japan and later from Korea and Taiwan began relocating some of their production facilities to other countries in East and Southeast Asia. Initially, they relocated only their labour intensive activities to Southeast Asia where wages were lower. Incidentally, the period also marked the emergence of production networks, driven primarily by lower transportation and telecommunication costs. The latter was a result of new information and communication technologies. Automotive and electronic industries are examples of industries with extensive production networks throughout the region. A production network is essentially a division (and subdivision) of labor within an industry where different countries or locations produce different parts and components of a product. This process is based on breaking a production (value) chain into small steps that enables firms to choose the most cost efficient location for each step within the value chain. But it is also possible that different firms from various countries interact with each other and form a production network. Athukorala and Yamashita (2005) argue that, since the early 1990s, intra-industry trade has grown faster in East Asia than in North America or Europe. Indeed, according to one estimate, more than 70% of intra-Asian trade consists of intermediate goods used in production and of this, half is driven by final demand outside Asia. Meanwhile, China's final demand accounted for only 6.4% of total Asian trade, which is only half of the contribution from Japan and slightly below a quarter of that from the US (ADB, 2008a).

It is tempting to include the demonstration effect as another factor that contributes to the rapid rise of Asia. A successful economic policy that leads to a rapid economic growth in one country will attract attention and eventually emulation by neighboring countries. Nevertheless, a closer look at the pattern of growth in the region clearly indicates that this is not always the case. Indeed, many countries in the region have adopted an export-led growth policy that, arguably, is responsible for the rapid growth in those countries. Yet, for one reason or another, toward the end of 2010, some countries in Asia remain relatively underdeveloped. North Korea and Myanmar, for ideological or political reason have chosen to keep their economies closed. Meanwhile, the govern-

ment of Pakistan and Bangladesh are politically too weak to push for economic reforms deemed necessary to propel them to a higher growth trajectory. Note that the demonstration effect works only if there are enough incentives for economic agents in a laggard country to emulate the successes in other countries. Quite often this means the government in question should liberalize its country's economy by removing various constraints that have prevented the economy from growing.

Indeed, in a provocative paper, Dollar (2007) argues that the rise of Asia is something of a myth. Asia is a large and heterogeneous region and has about half of the world's population. In particular he argues that since 1990s China's economic performance, measured in terms of GDP growth rate, has bested all other countries in the region. As noted earlier China's share in world GDP (PPP) has increased from 3.6% in 1990 to 13.2% in 2010 far exceeds that of India that increased from 3.0% to 5.5% during the same period. Meanwhile, the share of other East Asian countries (ASEAN, Japan and Korea) has in fact declined from 13.8% to 11.9%. As it is, China was responsible for most of the region's gain during the period under consideration (Figure 1).

With regard to trade, just recently China has surpassed Germany as the world's largest exporter. Its trade began to pick up pace especially after 2000 (Figure 2). In 2008 its export has exceeded 1.4 trillion dollars while its import exceeded one trillion dollars. Because of the global financial crisis both its export and import were somewhat lower in 2009 but bounced back afterwards. China's vast labor force and expanding skill base imply a huge potential for production. For any country, the rise of China will undoubtedly generate both great expectation as well as anxiety. On one hand, China, with a population of over 1.3 billion, offers a huge potential market for its products. On the other hand, there is a concern particularly among developing countries that, given China's proven competitiveness, they will not be able to compete with it in the global market. A temporary suspension by the United States (US) and the European Union (EU) of textile and clothing imports from China in early 2005 following the termination of multi fiber agreement is a case in point. The US and the EU were concerned that other developing countries would not be able to compete with China in this respect. But more developed countries also share a similar concern as China is exporting ever-more-sophisticated products.

Yet, as Dimaranan et al., (2007) argue, some recent developments have the potential to attenuate the above concern. First, trade in manufactures runs both ways and countries tend to benefit from improved efficiency in their trading partners. Second, the rise of global production sharing noted above increases the range of international division of labor and, hence, provides each country with a far greater number of entry points into the global market. Third, on a related issue, the range of products that a country can export has increase substantially in recent decades.

Moreover, it has also been suggested that the rise of China has some positive international spillovers. Arora and Vamvakidis (2010) show that spillover effects from growth in China to the rest of the world have increased over time and the effect declines with distance from China. They estimate, for instance, that a one percent increase of growth in China is correlated with faster growth by 0.32 percent in Korea but the correlation becomes zero or negative for countries at least as far from China as Jamaica. However, they also show the role of distance diminishes over time. The paper does not address the simultaneity issue, however; causality may in fact run both ways.

Finally, there is a sign that as labor costs in China continue to rise, some foreign companies will begin to look to other locations outside China, such as Vietnam and Indonesia, where labor costs are still relatively low. It should be noted, however, that Indonesia has not been able to capitalize on this opportunity primarily because it faces some major constraints, most notably a lack of almost all forms of infrastructure.

One unintended consequence of the global economic shift is a rising rivalry between China and the US. It seems certain that the dynamic of the Asian Pacific economic cooperation will be closely intertwined, for better or for worse, with the dynamic of the Sino-US relationship. Perhaps a rivalry is inevitable in a situation where one power is challenging the supremacy of the other. It is particularly so because, as Eichengrees (2011) points out, a shift in economic power always comes with a shift in military power. Rivalry is not necessarily a bad thing. Indeed, it is conceivable that a rivalry can bring the best out in both rivals. It all depends on how the rivals manage their relationship. It also depends to a certain extent on how the big powers manage their rela-

tionships with smaller countries. A big power needs to assure smaller countries that they will not be treated unfairly, let alone be threatened, in all matters that are relevant to their bilateral relations. This is especially true for an emerging big power that does not have a track record as a big power to begin with.

Proliferation of Free Trade Arrangements in Asia Pacific: A Brief Review

Regionalism, a byword for a formal economic integration, did not play any role in the early years of the regional integration process in East Asia. During the period of aggressive trade liberalization in the 1980s and 1990s, ideas to form a formal, tighter, regional economic integration in the region were not enthusiastically embraced. Indeed, the idea of East Asian Economic Caucus (EAEC) promoted by the then Prime Minister Mahathir of Malaysia in early 1990s withered away because it failed to garner necessary support, in particular, from major economies in the region such as Japan and Singapore.

ASEAN Free Trade Area (AFTA) was the first concrete attempt to create a formal regional economic integration. It dealt only with trade in goods and the plan was to allow preferential tariffs for trade between ASEAN members through the Common Effective Preferential Tariff (CEPT) scheme. Under the scheme, tariffs for most goods traded within ASEAN were lowered to the 0-5% range by January 2002. Notwithstanding the CEPT scheme, intra-ASEAN trade share has not grown significantly with implementation of AFTA. The utilization rate of AFTA preferential tariff rates has been low. One reason according to Baldwin (2006) is that AFTA's margins of preference on the high trade-volume goods are too small to compensate for the administrative cost and delay of applying for the CEPT. Given that the margins of preference are thin, it is no surprise that AFTA was almost never used. With regard to advancing regional trade in services and stimulating cross border investment activities, ASEAN introduced two schemes i.e., ASEAN Framework Agreement on Services (AFAS) and ASEAN Investment Area (AIA).

Despite AFTA, ASEAN member states continued to pursue unilateral economic liberalization. In this case, they have been fairly consistent. Even the 1997/98 East Asian financial crisis did not seem to have

significant effect on this pursuit. None of the member states reversed their commitment to liberalization because of the crisis. That said, it should also be stated that, in general, their liberalization programs were only partial when they should be arguably more comprehensive.

Meanwhile, in 1994, members of ASEAN, along with other East Asian countries, adopted the Bogor Declaration – with its principle of “open regionalism” – in the Asia-Pacific Economic Cooperation (APEC) summit. “Open regionalism”, though never explicitly defined, principally aims at ensuring that regional trade arrangements would not become stumbling blocks for global liberalizations (Bergsten, 1997). Or, in the words of the Bogor Declaration, with this principle APEC was to achieve free and open trade and investment in Asia-Pacific “in a GATT-consistent manner” – essentially emphasizing multilateralism.

This favorable sentiment towards a multilateral approach to trade liberalization in the Asia-Pacific region began to change by the end of the century. The failure of APEC’s Early Voluntary Sector Liberalization (EVSL) as well as the 1999 WTO Seattle Ministerial meeting casted doubt on the multilateral approach (Scollay, 2003).⁴

In East Asia, a number of factors triggered changing attitudes with regards to regionalism. First, the 1997 economic crisis triggered a sense of economic solidarity in the region, partly due to widespread disappointment of what was perceived as the slow response of developed countries in preventing a prolonged economic crisis. Some countries in East Asia that had not previously embraced the use of preferential agreements began experimenting with bilateral trade agreements (BTA) and FTAs.

Another factor was the increased engagement of China in global trade. Fresh from successful accession to the WTO, China was interested in opening access to various economies’ markets while obtaining raw inputs for its industries. An FTA is a strategic device given China’s bargaining position. This, in turn, initiated further FTA efforts, both

⁴ There was no surprise about the failure of EVSL: the voluntary nature of the agreement signaled an inability of the parties to the agreement to pre commit. Without high enough mutual trusts among the parties, any attempt by one country to voluntarily liberalize a certain sector would likely to encounter resistance from the industry in question. In essence, the voluntary nature of the agreement puts the first mover in a disadvantage position vis-à-vis the rest. In a way it may be argued that EVSL was introduced too soon, when APEC countries were still trying to build mutual trusts among themselves.

from those in East Asia who do not want to be left behind in terms access into the Chinese market, as well as those who do not want to lose their dominant position in the region to China.

In addition and somewhat related to the above, one may argue that the rapid rise of Asia has also contributed to the proliferation of FTAs involving Asian countries. As noted earlier, the region's rapid economic growth has been driven by trade, while some Asian countries have a larger trade volume than the size of their economy. It is natural that these countries would want to continue expanding the markets for their products as well as securing a supply of resources. One way to achieve these objectives is through an FTA.

Finally, by early 2003 the US began propounding a strategy of "competitive liberalization" that perceived global, regional, and bilateral trade as complements of each other (Soesastro, 2003a). Putting this strategy into practice, the US signed a bilateral trade agreement with Singapore in 2003. Given its pivotal role in the global trading arena, the US's embrace of FTAs sets an example for others in the Asia-Pacific region.

So far, the ASEAN – China Free Trade Area (ACFTA) initiative was the most significant attempt to create free trade area in the region. The initial framework agreement was signed in November 2002 in Phnom Penh, Cambodia. The free trade area came into effect on 1 January 2010, creating the largest free trade area in terms of population. ASEAN and China together have a combined population of over 1.9 billion. In 2008, they have a combined nominal GDP of around \$5.836 trillion, well below that of the European Union (EU) and North America Free Trade Area (NAFTA) with nominal GDPs of around \$18.387 trillion and \$16.792 trillion respectively. But ACFTA has, by far, the fastest growing economy of the three regions.

The ACFTA agreement prompted other countries in the Asia Pacific such as Japan, Korea, India and, Australia and New Zealand to also seek a closer economic cooperation with ASEAN. So far ASEAN has reached an agreement to establish a free trade area all these countries.

Meanwhile, in Southeast Asia, discussions to bring integration within ASEAN a step further intensified, culminating in the 2003 ASEAN Concord II which declared the intention to achieve an ASEAN

Economic Community (AEC) by 2020. The idea of establishing AEC came to be partly as a response to a rapid rise of China and India as major economic powers in the region. The concern was without a unified effort it would be difficult for ASEAN member countries to compete with China and India both within ASEAN as well as in global markets. Hence, the AEC Blueprint states that the AEC 'will establish ASEAN as a single market and production base making ASEAN more dynamic and competitive'. Subsequently, ASEAN decided to speed up the establishment of the AEC to 2015.

With regard to Indonesia, so far it has signed eight FTAs, seven of which are being implemented (Table 1). Out of the seven, only one is a bilateral FTA, namely, the Indonesia-Japan Economic Partnership Agreement (IJEPA). The others are as a member of ASEAN FTA agreements, including AFTA. This indicates that Indonesia has not been very keen to pursue free trade agreements with other countries on its own. This is partly because FTAs have not been politically very popular among the country's political elite. For example, right after ACFTA came into force, the government was under pressure to renegotiate the agreement with the Chinese government. The pressure came not only from the private sector but also from members of parliament and even from within the government itself. Note that in Indonesia, trade agreements do not require parliament's ratification. The government only has to notify the parliament about such an agreement. The rule is meant to expedite the implementation of such an agreement.

The rapid proliferation of FTAs poses a challenge to the existing network of regional economic activities or, to use Baldwin (2006), 'Factory Asia' from breaking down. According to Baldwin, Factory Asia is fragile for a number of reasons. Firstly, each economy's competitiveness depends on the effectiveness and functioning of intra-regional trade. This is because, as noted, an increasing fraction of the intra-regional trade constitutes trade in parts and components (intra-industry trade). A failure of one country (company) to deliver will affect the performance of other countries involved in the same production network. Secondly, so far many countries in the region have not bound their most favored nation (MFN) tariffs in the World Trade Organization (WTO) and, hence, cannot guarantee that they will not raise their tariffs in the future. The relatively low MFN tariffs are primarily the

result of unilateral liberalization programs and, therefore, are liable to reversal. Finally, as noted earlier, the noodle bowl syndrome threatens to inhibit the well functioning of intra-regional trade.

The Emergence of TPP Initiative

One way to prevent the breaking down of 'Factory Asia' is to create an East Asia-wide regionalism that will supersede existing FTAs involving countries within the region. Firstly, a single region-wide FTA will resolve the noodle bowl problem by replacing all existing ROOs in the existing FTAs with a single set of ROO. This, in turn, will ensure the well functioning of the region's production networks and, hence, enable economies in the region to improve or, at least, maintain their economic performance. Secondly, it will allow for greater policy coordination among the member countries. An Asian Development Bank's study finds that there is a deepening macroeconomic interdependence among the East Asian countries as a result of the region's growing trade and financial ties. Yet, there is little evidence of convergence of macroeconomic policies, despite the fact that increased macroeconomic interdependence requires greater policy coordination so as to improve their ability to undertake concerted actions, especially during the time of crisis. Implicit here is a notion that East Asia regionalism goes beyond a merely a free trade area. Rather, it aims at comprehensive economic cooperation. Important as it is, free trade is just a component of it.

At the moment countries in the region entertain two competing regional architectures, i.e., ASEAN Plus Three and ASEAN Plus Six. The ASEAN Plus Three grouping comprises all ASEAN member countries plus China, Japan and Korea, while the ASEAN Plus Six grouping encompasses all ASEAN Plus Three member countries plus Australia, India and New Zealand. It seems, however, that neither of these two groupings will become a formal regional institution in the near future. This is mainly because two the largest economies in the region, namely, China and Japan, are known to have been supporting different groupings. China favors ASEAN Plus Three while Japan favors ASEAN Plus Six. Meanwhile, so far, ASEAN, which is often regarded as the driving force behind the establishment of East Asian regionalism, has not been able to exercise the kind of leadership necessary to push the process forward.

In the meantime, another regionalism is taking shape vis-à-vis the Trans-Pacific Partnership (TPP). It is a preferential trade agreement (PTA) that aims to further liberalize the members' economies. The original agreement between the countries of Brunei, Chile, New Zealand and Singapore was signed in June 2005, and entered into force in May 2006. Prior to the APEC Summit in Honolulu, five additional countries, i.e., Australia, Malaysia, Peru, the United States and Vietnam, have become involved in the negotiation. Thus far, the TPP has missed the target set by President Obama for settlement of negotiations by November 2011. However, at the APEC Summit in Honolulu three other countries, i.e., Canada, Japan and Mexico, have expressed their interest on joining TPP. If indeed they join, the TPP will constitute 12 countries with a total GDP of around 40% of world GDP, well above that of NAFTA or the EU.⁵ Some economies in the region may see TPP as an opportunity to join such a large market. Some may also appreciate the promise that TPP will introduce a high quality, 21st century trade agreement. Others, however, may see the same promise as a barrier to entry. In short, one must also be mindful about potential pitfalls of such an ambitious undertaking. There are significant gaps in the levels of development among countries in the region.

The objective of the original agreement of the P-4 was to eliminate 90 percent of all tariffs between member countries by 1 January 2006, and reduce all tariffs to zero by the year 2015. It is a comprehensive agreement covering all the main pillars of a free trade agreement, including trade in goods, rules of origin, trade remedies, sanitary and phytosanitary measures, technical barriers to trade, trade in services, intellectual property, government procurement and competition policy. The TPP aims at essentially the same objective: achieving an agreement where all members commit to eliminate tariffs on all traded goods and at the same time adopts a high-quality approach to trade in services and other sectors.

Like any other international agreement, political considerations may also play an important role in a country's decision to enter a free trade agreement. This is especially true for a free trade agreement that involves major powers. There are a number of possible reasons why

⁵ See "Free trade in the Pacific: A small reason to be cheerful", *the Economist*, November 19th–25th 2001.

some developing countries from Asia decided to join the TPP. The first explanation is domestic in nature. A country chooses to join the PTA to promote further domestic economic reform. External pressure is often needed to push for necessary reforms. In Indonesia, for instance, the government has used its commitments to AEC to push for further economic reform. It is possible therefore that these countries want to use their commitments to TPP as justifications for further reforms. The second explanation is to get a greater access into the US market. It is one possible reason as to why they decided to join the PTA only after the US expressed its interest in joining. There is a third possible explanation and that is to counterbalance the rising China's influence in the region.

It remains to be seen as to how the actual agreement will look like. Yet, experts that have been following the TPP development closely caution about its potential shortcomings and the likely adverse effects it has on regional development in the Asia Pacific. Armstrong, for instance, argues that more than half of APEC members, including some key economies such as China and Korea, are undecided about joining TPP at this stage and they may find it difficult to join after the agreement has been reached. In addition, there is a risk that the APEC process could lose momentum, as some of its members are getting caught-up in TPP negotiations. Armstrong also points to a possibility that the TPP might be constituted of a number of bilateral agreements and hence create another noodle bowl.⁶

Meanwhile Indonesia has declined to join the TPP, at least for the time being. There are at least two reasons, according to media reports, behind this decision. The first reason is the government figures that Indonesian industries, services industries in particular, are not ready to compete against those from the TPP members. According to government officials, companies in these industries need time to boost their competitiveness in order to compete in domestic as well as regional markets. The second reason is Indonesia wants to focus its attention on AEC. This signals the government's limited capacity to implement multiple trade agreements at once.

⁶ Armstrong (2011), "The TPP, APEC and East Asia trade strategies", East Asia Forum, <http://www.eastasiaforum.org>

The decision reflects the difficulty Indonesia faces in its attempt to join an FTA such as the TPP. With regard to the TPP, on the one hand, the TPP provides Indonesia with an opportunity to increase its trade with NAFTA members, the US in particular, with which Indonesia does not yet have any free trade agreements. On the other hand, the government seems to realize that it will be difficult for Indonesia to meet all the provisions that are likely to emerge from the negotiations. This is particularly important since the negotiation will be conducted as a single undertaking. Any attempt to join the TPP at the moment is likely to face a stiff domestic opposition. Moreover, there is a sign that Indonesia is reversing its economic reforms.⁷ Domestic opposition toward free trade is noticeable, especially after the full implementation of ASEAN-China FTA. Indonesia was the last among the ASEAN members to sign ASEAN-Australia-New Zealand free trade agreement. Meanwhile, it has not been able to bring to conclusion the bilateral Indonesia-Australia-New Zealand free trade negotiation. In these two episodes, strong opposition from line ministries, such as the agriculture ministry, has slowed down the process.

As noted above, the Indonesian government is concerned about the level of competitiveness of the country's economy. Various reports indeed show relatively low competitiveness of the country's economy. For instance, in 2011 Indonesia ranked 37th out of 59 economies surveyed by the Institute for Management Development, Switzerland. The report shows a multiplicity of causes for its relatively low score in competitiveness. On business efficiency for example, the country ranks 33rd while on infrastructure it ranks very close to the bottom at 55th. Clearly, not all of these problems can be remedied through removal of all trade barriers and reforming the government in an accelerated way as the TPP is likely to require. Note that the TPP agreement is likely to include provisions on cross-cutting issues that will somewhat mitigate Indonesia's concern. For example, there will be a provision on competitiveness and business facilitation which aims at enhancing the domestic and regional competitiveness of each TPP country's economy. Another is on development which aims at, among other things, esta-

⁷ See Hill, Hal and Monica Wiharja "Indonesia's Reform Reversal", *The Wall Street Journal*, November 30, 2011

blishing a mechanism to help all TPP countries to effectively implement the agreement. Yet they are not sufficient to sway Indonesia to join the TPP.

One may therefore argue, based on the foregoing, that gradual liberalization and reform is the only way to address the concerns of developing countries such as Indonesia even if it is not the most efficient from an economic point of view. This does not, however, imply that the Indonesian government could therefore slow the drive to liberalize and reform the economy. On the contrary, as will be explored further below, the government should consider the TPP episode as warning as to how far the country's economy has fell behind other economies in the region. The paper simply argues that there may be other ways to include a country like Indonesia in a regional trade arrangement with targets as ambitious as those of the TPP.

There is also a prevailing concern among some Indonesian officials that the TPP could marginalize ASEAN or even erode its cohesiveness. There are at least two ways to go around this issue. The first is for the members to avoid undermining ASEAN centrality. All along ASEAN has insisted that the member countries pursue coherent external policies which implies, among other things, upholding ASEAN centrality in their external policies. This is clearly stated in the AEC Blueprint. The second is to prevent divisive issues from permeating the organization that could undermine its integrity. The stake is increasing with the degree of ASEAN integration. As ASEAN is increasingly integrated, the cost of disunity would increase accordingly. To put it differently, as ASEAN is increasingly integrated, it can no longer operate as a loose organization. Moreover, it may be argued that in a rapidly changing regional landscape, it is imperative for ASEAN not only to insist that its members should develop coherent external policies but more importantly that ASEAN itself pursues an independent external policy. This will also enhance its claim to be the driving force behind the region's effort to build an East Asian community.

The TPP is likely to have some ramifications on efforts to enhance East Asian regionalism as well. As Armstrong (2011) notes, recent developments in the TPP could re-energized cooperation between the East Asian countries, especially between China and Japan. Japan, for instance, is considering the establishing a bilateral FTA with China at

the same time as it joins the TPP. If this indeed is the case, it indicates that China-Japan relations are much closer than commonly assumed. It seems that Japan wants to send a signal that its move to join the TPP should not be seen as an attempt to alienate China. This could have a positive implication on East Asian regionalism. As noted earlier, until recently China has championed ASEAN Plus Three while Japan supported ASEAN Plus Six. Within current developments they may eventually be able to sort out their differences and decide on which platform they would like to support.

The fact that the initiative comes from Japan is significant for another reason. It indicates Japan's confidence that the negotiation will be among equals. This could help dispel an a priori belief held by some that ASEAN Plus Three will be dominated by China, a concern that the ASEAN Leaders clearly do not share. In fact the ASEAN Leaders just reiterated the importance of the ASEAN Plus Three as a main platform for East Asian community. The Chair's Statement of the 19th ASEAN Summit in Bali states that the ASEAN Leaders "reaffirm that the ASEAN Plus Three process would continue as a main vehicle towards the long term goal of building East Asian community with ASEAN as the driving force." The ASEAN Leaders also refer to some tangible achievements of the ASEAN Plus Three to date, including the establishment of ASEAN Plus Three Macroeconomic and Research Office in Singapore⁸

Finally, it is not surprising that China does not want to join the TPP. It is fair to argue, judging from the way China and the US has dealt with such issues as Yuan exchange rate, intellectual property right, etc., that the two will continue to agree to disagree on various issues, including those that are relevant to regional architecture in the Asia Pacific. This reinforces the argument made before that ASEAN should pursue an independent external policy. ASEAN cannot afford to get drawn into the rivalry of the two big powers.

By Way of Conclusion: Issues Going Forward

Indonesia has declined to join the TPP on grounds that its companies are not ready to compete with companies from TPP members in

⁸ See Paragraphs 119 and 120 of the Chair's Statement of the 19th ASEAN Summit.

the domestic as well regional markets. As argued above, the government should consider this episode as a wakeup call to address this problem. The risk of doing otherwise is that Indonesia will fall further behind. There is nothing new about Indonesia's lack of competitiveness. Various reports have pointed this out, including the IMD report cited earlier. What is clearly lacking is the resolve to address this issue squarely. Take, for example, the shortage of infrastructure that, according to the IMD report, is one of the country's weakest points. The government has produced short-term, medium-term and long-term plans and more recently, a master plan, to address this issue. Yet, according to the IMD report, there has not been any tangible improvement during the past few years. A lack of funds is clearly a problem. In this regard the government needs to consider issuing infrastructure bonds. But there are other problems such as, corruption, cumbersome regulations and procedures, etc., which have also adversely affected infrastructure development by discouraging the private sector from participating in the endeavor. The government should urgently address these issues in order for Indonesia to catch up with other economies in the region.

The government should also continue to liberalize the economy. One sector that has been pointed out by government officials as among the weakest is the services sector. There is a large and growing body of literature that argues that service sector liberalization will stimulate further growth, including the growth of the sector itself. There are a number of channels through which services trade liberalization can accelerate economic development. Firstly, it stimulates trades in goods and services by, among other things, reducing trade costs. Secondly, it stimulates foreign investment. And, lastly, it promotes production network and outsourcing.

The TPP has set the bar too high for some economies such as Indonesia to pass. Some richer economies, such as Korea have not joined the TPP perhaps because it is not conducive to join the bloc at this time around. Korea has just ratified the Korea-US FTA and during negotiations there have been some massive protests in Korea against the FTA. But arguably, poorer economies are more likely to stay out of the TPP than richer ones. This could perpetuate, if unintentionally, the rich - poor, developed - less developed dichotomy in the region. The would-be framers of the future East Asian community should be mindful of

this possibility. While on the trade part, the East Asian community should also aim at a similarly high standard as the TPP, yet such a standard should not be allowed to become a barrier for less developed economies to participate. That is, the program should be such that it allows the developing economies to liberalize their economies gradually and sequentially, akin to sequential liberalization in development economics, only this time it is not unilateral and with agreed upon time schedules. The program should also include facilitation mechanisms. In this respect, experiences and accomplishments of APEC as well as AEC are indispensable. While such an approach is perhaps not too efficient from an economic point of view, yet arguably it could help attenuate political opposition in developing economies to participate. It will make the word inclusive more meaningful.

As noted, ASEAN needs to ensure that its members pursue coherent external policies. One approach is to establish a regional mechanism for closer consultation and coordination among the ASEAN members. Consultations should not be limited only among government officials but should also include relevant stakeholders, with the view to facilitate the process of arriving at regional negotiating positions in ASEAN's free trade and comprehensive economic partnerships negotiations with dialogue partners. In addition, ASEAN should consider developing templates to be used as guidelines by ASEAN negotiators in negotiating trade, investment and FTA agreements. When it is possible, ASEAN should clearly indicate the external policy options that can be taken by the members. At the same time it should make sure that members can see the long-term benefit of these options. Also, ASEAN members should alert each other when planning to enter negotiations to establish preferential trade arrangements with other countries. ASEAN should provide a set of guiding principles that would be used by ASEAN members in their negotiations. Such a guideline should not be as rigid as a template.

ASEAN should take a more active role in shaping the future direction of the effort to establish an East Asian community worthy of the claim that ASEAN is the driving force behind this endeavor. In particular, ASEAN should make up its mind concerning which template or platform of regionalism that it would support: ASEAN Plus One, ASEAN Plus Three or ASEAN Plus Six. This would eliminate any un-

certainty and set the process into motion. It should be clear by now, following the recent TPP development that the longer it waits, the more difficult things will become. ASEAN and other countries in the region should also make sure that the China-US rivalry does not stymie regional efforts to establish an East Asian community. It is therefore imperative for ASEAN to maintain an independent external policy vis-à-vis the two big powers.

REFERENCES

- ADB. 2008. *Emerging Asian Regionalism: A Partnership for Shared Prosperity*, Manila: ADB.
- ADB. 2008a. *Uncoupling Asia: Myth and Reality*, Manila: ADB
- Armstrong, Shiro. 2011, "The TPP, APEC and East Asia trade strategies", East Asia Forum, <http://www.eastasiaforum.org>
- Arora, Vivek and Athanasios Vamvakidis. 2010. *China's Economic Growth: International Spillovers*, IMF Working Paper No: WP/10/165
- ASEAN. 2011. "The Chair's Statement of the 19th ASEAN Summit", available at <http://aseancec.org/>
- Athukorala, Prema-chandra and Nobuaki Yamashita. 2005. "Production Fragmentation and Trade Integration: East Asia in Global Context," Canberra: Research School of Pacific and Asian Studies Working Paper, Australian National University.
- Baldwin, Richard. 2006. "Managing the Noodle Bowl: The Fragility of East Asian regionalism", Geneva: Graduate Institute of International Studies Working Paper.
- Bergsten, Fred. 1997. "Open Regionalism". IIE Working Papers 97-3.
- Dimaranan, Bettina, Elena Ianchovichina and Will Martin. 2007. "Competing with Giants: Who Wins, Who Loses?", in L. Alan Winters and Shahid Yussuf (eds.), *Dancing with Giants: China, India and the Global Economy*, Washington D.C.: World Bank
- Dollar, David. 2007. *Asian Century or Multi-polar Century? A paper prepared for the Global Development Network annual Conference: "The Rise of Asia"*, Beijing, China, January 2007.

- Eichengreen, Barry. 2011. "Global Shift", paper presented at the Bank of Finland's 200th anniversary symposium, Helsinki May 5 -6
- Grossman, Gene M., and Elhanan Helpman. 1995. "The Politics of Free Trade Agreement", *American Economic Review*, vol. 85, no. 4 pp 667-689.
- Kim, Soyoung, Jong-Hwa Lee and Cyn-Young Park. 2010. "The Ties that Bind Asia, Europe and United States", ADB Economics Working Paper Series No. 192
- Ng, Francis and Alexander Yeast. 2003. "Major Trade Trends in East Asia: What are their Implications for Regional Cooperation and Growth?" Washington: The World Bank Policy research Working Paper No. 3064
- Scolay, Robert. 2003. "RTA Development in the Asia-Pacific Region: State of Play", paper presented at the PECC Trade Forum, Phuket, Thailand, May 25
- Soesastro, Hadi. 2003. "Dynamic of Competitive Liberalization in RTA Negotiations: East Asian Perspectives", paper presented at PECC Trade Forum, Washington DC, April 22- 23
- Soesastro, Hadi. 2003a. "Challenges to APEC Trade Policy: The Doha Development Agenda and RTAs/FTAs", CSIS Working Paper WPE 069
- The Economist. 2011. "Free trade in the Pacific: A small reason to be cheerful", November 19th -25th
- Hill, Hal and Monica Wiharja. 2011. "Indonesia's Reform Reversal", The World Street Journal November 30th
- USTR. 2011. "Enhancing Trade and Investment, Supporting Jobs, Economic Growth and Development: Outlines of the Trans-Pacific Partnership Agreement" available at www.ustr.gov/.../outlines-trans-pacific-partnership-agreement -
- Winters, L. Alan and Shahid Yusuf (eds.). 2007. *Dancing with Giants: China, India and the Global Economy*, Washington D.C.: World Bank

APPENDIX

Table 1. FTA Status (Selected Countries), as of July 2011

Country	Pro- posed	Under Negotiation		Concluded and Signed		TOTAL
		FA Signed/ Under Ne- gotiation	Under Ne- gotiation	Not yet In Effect	In Effect	
Australia	3	2	8	0	8	21
Brunei Dar- ussalam	4	2	1	0	8	15
Cambodia	2	0	1	0	6	9
PRC	6	2	4	0	12	24
Hong Kong	1	0	0	1	2	4
India	8	4	8	0	13	33
Indonesia	6	2	3	1	7	19
Japan	6	0	2	1	12	21
Korea	14	2	5	1	8	30
Lao PDR	2	0	1	0	8	11
Malaysia	6	1	5	2	10	24
Myanmar	2	1	1	0	6	10
New Zealand	3	1	5	0	9	18
Philippines	4	0	1	0	7	12
Singapore	4	1	9	3	18	35
Taipei, China	1	1	1	0	5	8
Thailand	6	4	3	0	11	24
Viet Nam	5	1	2	0	7	15

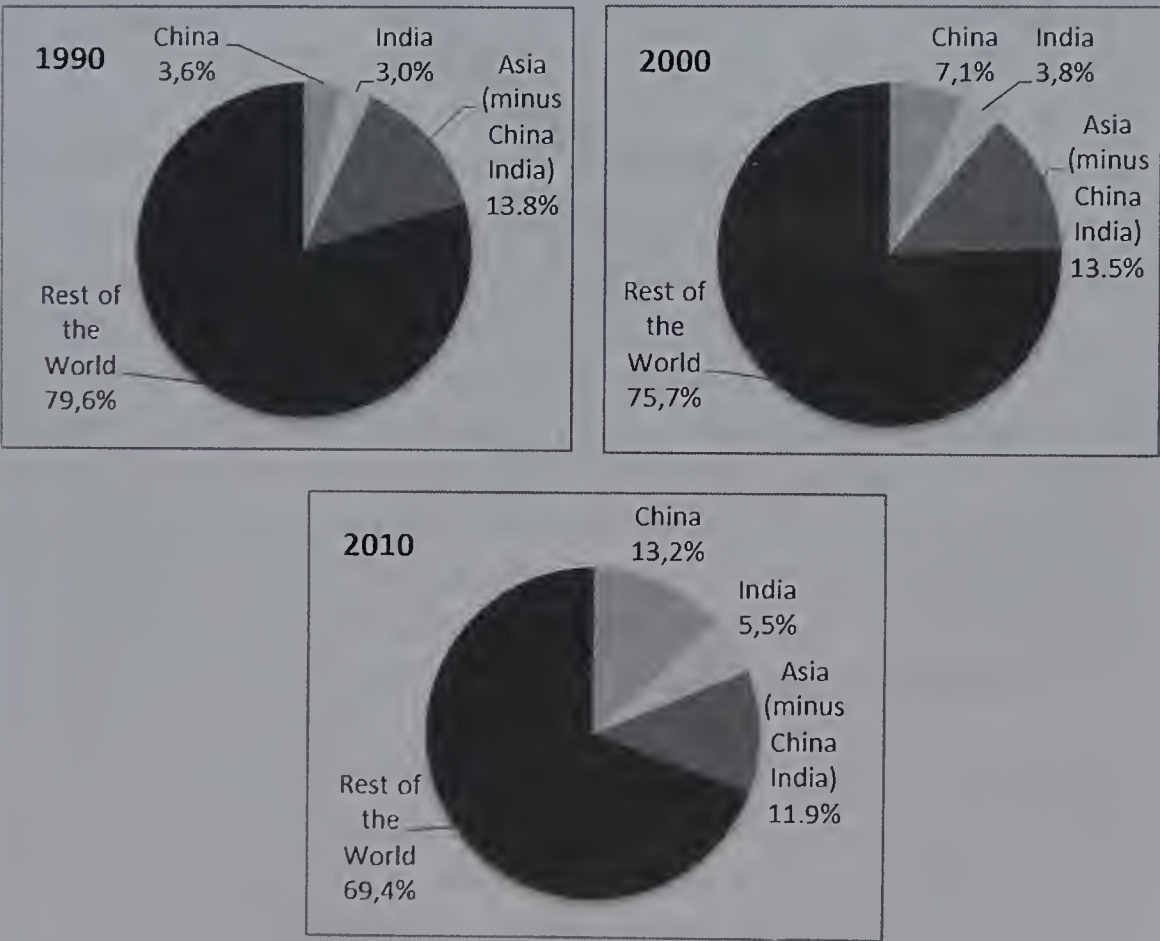
Source: Asia Regional Integration Center, ADB

Note:

1. Proposed - parties are considering a free trade agreement, establishing joint study groups or joint task force , and conducting feasibility studies to determine the desirability of entering into an FTA.
- 2a. Framework Agreement Signed/Under Negotiation - parties initially negotiate the contents of a framework agreement (FA), which serves as a framework for future negotiations.
- 2b. Under Negotiation - parties begin negotiations without a framework agreement (FA).

- 3a. Signed but not yet In Effect - parties sign the agreement after negotiations have been completed. Some FTAs would require legislative or executive ratification.
- 3b. Signed and In Effect - when the provisions of an FTA becomes effective, e.g., when tariff cuts begin.

Figure 1. Percentage Share in World GDP, PPP
(current international \$)

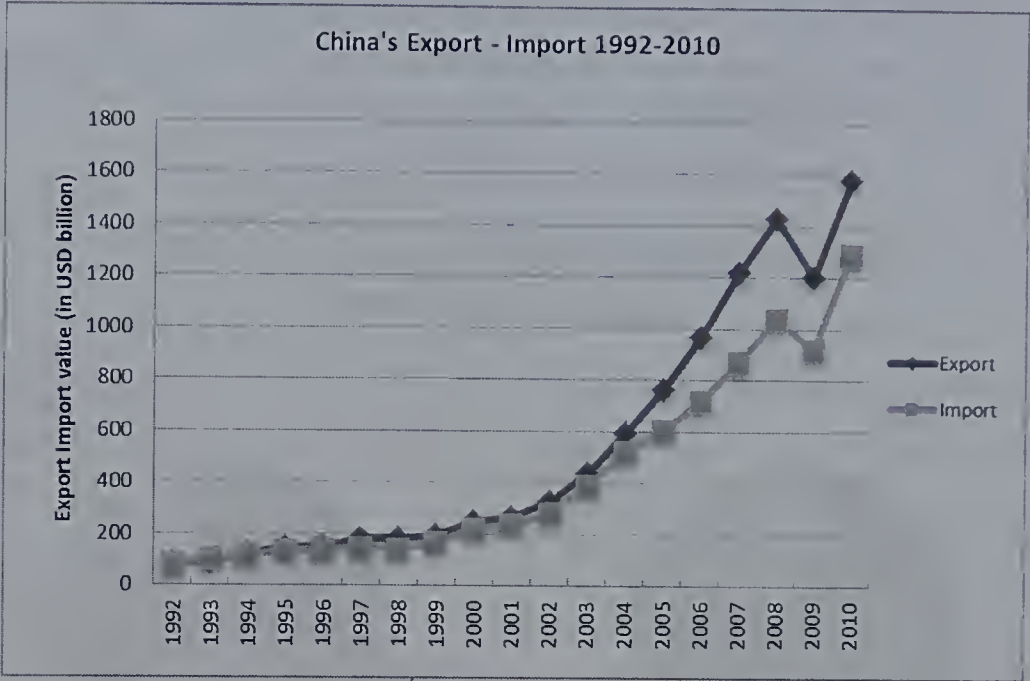


Source: World Development Indicator Online

Note:

ASIA consists of China, India, Korea, Japan, Hong Kong, and ASEAN
In 1990, ASEAN excludes Myanmar and Cambodia
In 2000, ASEAN excludes Myanmar
In 2010, ASEAN excludes Myanmar and Brunei Darussalam

Figure 2. China's Export and Import 1992-2010



Source: UN Comtrade Database

Europe's interests in Indonesia: What is to gain from closer cooperation?

*Manuel Schmitz*¹

Introduction

Europe today looks to the East. While transatlantic relations remain important for the EU and its member states, European elites and public turn their eyes more and more to Asia, especially in the current economic crisis. Asia appears to be the next powerhouse of globalization, posing new challenges and opportunities for Europe in an interconnected and interdependent world. It is especially the People's Republic of China that fires hopes and anxieties in Europe, but India and Japan are also on the European radar. All three states are labelled "strategic partners" by the European Union (EU), i.e. the EU wishes to strengthen ties with these countries hoping to foster an effective multilateralism on the global stage.

And what about Indonesia? In Europe's media the archipelago state is rarely portrayed as an economy with high growth rates or a market with huge export potential, nor is Indonesia considered to be an important global player. At the level of the political elite this perception might differ, but Jakarta is certainly not as high on the agenda as Beijing or New Delhi. It was, for example, only in November 2009 that Indonesia and the EU signed a Partnership and Cooperation Agreement (PCA), agreeing to cooperate on a wide range of issues, from trade and energy to environment and education. While this instrument

¹ Manuel Schmitz (Ph.D.) is Lecturer at the Chair in International Relations and Foreign Policy at the University of Trier, Germany. He has written two books on Indonesian politics published in German. Currently he is researching the Asia strategy of the European Union.

raised the profile of the relationship it also demonstrated the difference of importance attached to Indonesia, labelling Jakarta only a partner without the qualification “strategic”.

It is interesting to note that the signing of the PCA was delayed for over two years because of a dispute over aviation safety. In July 2007, the European Commission following negative findings of the International Civil Aviation Organization (ICAO) imposed a flight ban in Europe on all Indonesian airlines. This triggered angry reactions in Indonesia. Only after the ban was lifted in June 2009 Jakarta agreed to sign the PCA.² The Indonesian career diplomat responsible for the negotiations, Retno Marsudi, explained in an article for the Jakarta Post the end of the ban meant that “a pebble in the shoe” was now gone.³

Many years before Indonesia’s then foreign minister, Ali Alatas, had used the same phrase to describe the East Timor problem. The annexation of the former Portuguese colony had strained the European-Indonesian relations for decades, especially after Portugal had joined the European Community (EC) in 1986. That a rather technical issue such as air safety regulations could be the main obstacles of further cooperation between Jakarta and Brussels shows that the two actors at least don’t differ on more fundamental questions, such as human rights and democracy. This sets the relations apart from other cases, especially the EU-China relations.

Because Indonesia is a democracy one should expect that it would be a “natural” ally for the EU. After all, the EU is a club of 27 democracies and an actor with a distinctive normative outlook in international affairs.⁴ But it seems that Europe gave more attention to Indonesia when it was still an authoritarian regime than in the years after its democratic transition. The human rights violations of the Suharto regime may have been a burden on the relations between Europe and Indonesia, but at least Jakarta was on the agenda. It is a bitter irony that democracy has not yet paid off in diplomatic terms for Indonesia.

² Garuda Airlines currently only serves Amsterdam but is planning to expand its reach in Europe in 2013.

³ Retno Marsudi, “EU Ban: The Pebble in the Shoe is gone,” *Jakarta Post*, 13 July 2009.

⁴ Nathalie Tocci, “Profiling Normative Foreign Policy: The European Union and its Global Partners”, in idem, ed., *Who is a Normative Foreign Policy Actor? The European Union and its Global Partners* (Brussels: Centre for European Policy Studies, 2008), 2-3.

The existence of a vibrant democracy is not a sufficient incentive for Europe to engage with Indonesia.

If common values are not enough to make Europe aware of Indonesia, maybe rational interests are? The purpose of this paper is therefore to outline the potential merits of closer cooperation with Indonesia, to show what the Southeast Asian state has to offer to Europe. It will do so by looking at European interests in the field of security, economics and diplomacy.

When talking about interests, however, a word of warning is necessary. The term "interest" especially in the combination with the adjective "national" is hotly debated in the academic field of international relations.⁵ In the following the term "interest" will be used in its most simple form as advantage or benefit that a rational actor will seek to obtain. The question then is what benefits do the EU and its member states have to gain from good relations with Jakarta?

Security Interests

Europe and Indonesia do not in any way threaten the territorial integrity of each other. Nor is the EU or one of its member states a global superpower eager to ensure that Southeast Asia does not fall under the influence of an external hegemon, as it is of concern for the United States.⁶ And while Australia is well aware of possible negative spill over effects resulting from domestic instability in Indonesia or foreign policy adventures by Jakarta, this cannot be said for Europe.⁷

At first glance the geographic distance between Jakarta and Brussels, around 7.000 miles, provides a security comfort zone. But in a globalized world, in which states, societies and markets are connected by countless strings, geography loses political importance. Indeed, globalization affects European security calculations, as can be seen in the European Security Strategy (EES) of 2003. In this document – which forms the basis of the Common European Security and Defence Policy

⁵ Scott Burchill, *The National Interest in International Relations Theory* (London: Palgrave, 2005).

⁶ Ann Marie Murphy, "US Rapprochement with Indonesia: From Problem State to Partner," *Contemporary Southeast Asia*, Vol. 32, No. 3 (2010), 364.

⁷ See for the Australian perspective: Hadi Soesastro, "Indonesia as Australia's Neighbour," in Chris Manning and Peter van Diermen, ed., *Indonesia in Transition: Social Aspects of Reformasi and Crisis* (Singapore: Institute of Southeast Asian Studies, 2000), 134

of the EU – the identified key threats are: terrorism, proliferation of weapons of mass destruction, regional conflicts, state failure, and organised crime.⁸

Not all of them are relevant in the case of Indonesia. While many Western commentators at the end of ninety-nineties feared Indonesia would break up, Indonesia today can hardly be seen as a fragile nation.⁹ There are some disputes in the region, notably the unresolved territorial claims in the South China Sea, but there is no imminent regional conflict. Indonesia recently ratified the Nuclear-Test-Ban-Treaty and is considered probably more as a partner than as a threat in this policy field by European security thinkers. But there are two other issues that should raise concern at the moment: terrorism and organised crime.

Europe has faced many terrorist challenges in recent history, ranging from separatists to left wing radicals, but today Islamic militants are seen as the most imminent threat by Europe's decision-makers. The terrorist attacks in Madrid (May 2004) and London (July 2005) killed over 250 people in total, demonstrating the imminent danger posed by radicalised Muslims. Indonesia, too, has been the site of terrorist attacks, taking in some instances the lives of Europeans: 49 of the 202 dead of the Bali bombings of October 2002 were citizen of the European Union, the assault on the Marriott Hotel in August 2003 resulted in the deaths of two (out of twelve victims) and in July 2009 two Dutch nationals died in suicide bombings in Jakarta. With around one million Europeans visiting Indonesia in 2010 and with the hope of increased tourism flows after the lifting of the flight ban there is always the possibility of European tourists becoming the target of terrorist actions in Indonesia.¹⁰

On the other hand Indonesia has so far not been a training ground for terrorists targeting Europe, unlike Pakistan or Afghanistan. The country is certainly not a safe haven for jihadists. Since the Bali bombings, the Indonesian government has been committed to fight the Is-

⁸ European Union, *A Secure Europe in a Better World. European Security Strategy* (Brussels, 12 December 2003), available online: <http://www.consilium.europa.eu/uedocs/cmsUpload/78367.pdf> (accessed 2 March 2011).

⁹ Indonesia's classification in the "warning category" of the Failed State Index 2011 may say more about the index than about Indonesia.

¹⁰ Peter Gelling, "European Union Lifts Ban on Indonesian Airlines," *New York Times*, 15 July, 2009.

lamic terrorism, despite the fact that large sections of Indonesian society are sceptical of the threat posed by Islamic radicals.¹¹ The unpopularity of America's "war on terror" resulted in a low key anti-terrorist campaign that has been focused on intelligence and police operations, but which showed nevertheless results in the fight against terrorism.¹² The risks of direct attacks on Europeans committed by Indonesians, executed on Indonesian soil or planned in Indonesia should therefore not be overestimated.

While Indonesia may not be an important battle ground in Europe's fight against jihadists it has nevertheless an important role to play in this struggle. With around ninety percent of its 237 million citizens being Muslims, Indonesia is the world's largest Muslim nation. The beliefs and practices of Indonesian Muslims have been traditionally less fundamental and austere than in the Middle East, but in recent decades a more orthodox interpretation of Islam seems to be on the rise. There are, however, religious tensions, not only between Muslims and Christians but also within the Muslim community. But as Geoffrey Hainsworth has put it: "...most scholars and commentators continue to emphasise that the vast majority of Indonesian Muslims are moderate in their beliefs and attitudes, peaceful rather than fervent in disposition, and generally tolerant and open-minded towards people with different values and ideologies."¹³ In many ways Indonesia therefore resembles Europe's "dream partner" in the global fight against militant Islam: the country is a pluralistic democracy and a Muslim nation. Brussels hopes Indonesia can be an example in the Muslim world and a bridge towards it, a role model and a moderate voice in the interfaith dialogue.¹⁴

The second threat mentioned in the EES with relevance for Indonesia is organised crime. It is interesting to note that the EES highlights

¹¹ Anthony L. Smith, "Terrorism and the Political Landscape in Indonesia: The Fragile Post-Bali Consensus," in Paul J. Smith, ed., *Terrorism and Violence in Southeast Asia: Transnational Challenges to States and Regional Stability* (Amonk/London: M.E. Sharpe, 2005), 98.

¹² Senia Febrica, "Securitizing Terrorism in Southeast Asia," *Asian Survey*, Vol. 50, No. 3 (2010), 583.

¹³ Geoffrey Hainsworth, "Rule of Law, Anti-corruption, Anti-terrorism and militant Islam: Coping with Threats to Democratic Pluralism and National Unity in Indonesia," *Asia Pacific Viewpoint*, Vol. 48, No. 1, 136.

¹⁴ Manuel Schmitz, "Das Wunschbild der EU: Betrachtungen anlässlich des EU-Indonesientages 2006," *Südostasien*, Vol. 23, No. 1 (2007), 63-64.

in the context of organised crime especially the issue of piracy. Indeed, since December 2008 the EU is engaged in a naval military operation, called *Atalanta*, against pirates in the Horn of Africa. With this mission the EU not only serves humanitarian purposes, i.e. to protect the shipping of aid to Somalia, but also pursues more selfish interests by protecting an important economic waterway: the passage through the Suez Canal.

But for the global economy the Malacca Strait, to which Indonesia is a littoral state, is of far greater importance, since the traffic volume in the Malacca Strait is four times that of the Suez Canal, and even ten times that of the Panama Canal.¹⁵ A considerable percentage of trade between the EU and the East Asian economies passes through these waters. It is estimated that in 2006 merchandise trade worth around 3.8 trillion Euros, or the equivalent of more than 26 percent of EU total trade volume, passed through the Malacca Strait.¹⁶ Take for example trade with China, the EU's second-largest trade partner. In 2010 around 72.7 percent of EU's combined imports and exports with China were by ship.¹⁷ Most of this trade was likely to pass through the Malacca Strait because this is the route preferred by most shipping companies. And it is not China alone that is of great importance to Europe's economies: In the top ten of the EU's trade relations Japan ranks six and India eight, while South Korea and Singapore hold the positions nine and twelve.¹⁸ Clearly any disruption of the flows of goods through the Malacca Strait – be it because of piracy or because of terrorism – is of concern to the EU.

However, as the issue of terrorism, the piracy problem should be put in perspective. Over the past decade piracy in Southeast Asia has attracted a lot of attention from scholars, journalists and decision-ma-

¹⁵ Xiaolong Wang, "Regional Governance in the Malacca Straits", *China-ASEAN Project Occasional Paper*, No. 22 (Canberra: Hong Kong, 2008), 1.

¹⁶ Heather Gilmartin, "EU-U.S.-China: Cooperation in the Malacca Strait", *Hamburger Beiträge zur Friedensforschung und Sicherheitspolitik*, No. 151, (Hamburg: Institut für Friedensforschung und Sicherheitspolitik, 2008), available online: <http://www.ifsh.de/pdf/publikationen/hb/hb151.pdf> (accessed 28 March 2011).

¹⁷ See for the figures the "External Trade Data Base" of the European Union", last modified 25 March 2011, available online http://epp.eurostat.ec.europa.eu/portal/page/portal/external_trade/database (accessed 4 April 2011).

¹⁸ Eurostat, "Top Trading Partners", last modified 16 March 2011, <http://trade.ec.europa.eu/doclib/html/122530.htm> (accessed 4 April 2011).

kers, not only in the region but also worldwide. And since two-thirds of reported attacks in Southeast Asia between 2002 and 2006 occurred in Indonesian waters, it was especially Indonesia that was under international scrutiny.¹⁹ However, since 2005 the number of attacks declined significantly to a degree that some authors even ask if there still exists a serious piracy problem in the Strait of Malacca.²⁰ The 2010 Annual Report of the Regional Cooperation Agreement on Combating Piracy and Armed Robbery against Ships in Southeast Asia (ReCAAP) lists only four actual incidents (plus three attempted) in the Malacca Strait. Because ReCAAP's definition of the Strait does not include the coastal waters of Indonesia and Malaysia one has to include the 36 reported incidents in Indonesian waters off the coast of Sumatra to get the full picture.²¹ Considering, however, that between 60,000 and 90,000 vessels pass this waterway every year it is fair to say that piracy in this region is not a major concern for the international community today. Of course, should Indonesia or its neighbouring states face domestic turmoil and chaos, this could change.

Economic Interests

What are Europe's interests in the economic sphere? First, Indonesia is a place to invest. Labour costs in Indonesia are lower than in any other Southeast Asian country, with the exception of Vietnam.²² But Indonesia's labour costs are not only attractive in the ASEAN context. If the hourly wage cost in major agglomerations is taken as indicator for manpower competition then Indonesia clearly beats countries like India, China or Mexico.²³ This advantage is somehow modified by rigid labour laws, a difficult business environment, poor infrastructure, and protectionist tendencies in Indonesia's trade policy. For example the

¹⁹ Ian Storey, "Maritime Security in Southeast Asia: Two Cheers for Regional Cooperation," *Southeast Asian Affairs*, 2009, 38.

²⁰ Catherine Z. Raymond, "Piracy and Armed Robbery in the Malacca Strait: A Problem Resolved?" *Naval War College Review*, Vol. 62, No. 3 (2009), 31-42.

²¹ ReCAAP, *Annual Report*, (Singapore: ReCAAP, 2011), 22.

²² Ames Gross and Andrew Connor, "Indonesia in the Global Financial Crisis: What HR Managers Need to Know," last update March 2009, <http://www.pacificbridge.com/publications/indonesia-in-the-global-financial-crisis-what-hr-managers-need-to-know/> (accessed 29 April 2011).

²³ Global Production, "Labour Cost. Measures hourly wage cost in major agglomerations," last update March 2008, <http://www.global-production.com/scoreboard/indicators/labourcost.htm> (accessed 25 May 2011).

"Doing Business" index of the World Bank ranks Indonesia only place 121 of 183 economies.²⁴ And the Corruption Perception Index 2010 of Transparency International lists the country only on place 110 out of 178.²⁵ But despite the difficulties there are currently 700 European companies present in Indonesia, which invested 50 billion US Dollar in the Indonesian economy.²⁶

Low labour costs may be one reason to invest in the country. The other one – and here Indonesia differs from competitors such as Thailand, Vietnam or Singapore – is its huge domestic market. Indonesia may not be China or India, but is nevertheless a demographic and geographic giant. The Southeast Asian state has the world's 4th largest population and a territory of 1.9 million square miles (including the ocean waters), providing ample opportunities to do business.²⁷

After the painful Asian financial crisis of 1997/98 the country's economic development has been in recent years an economic success story. The average GDP growth rate in the last five years (2006-2010) was 5.7 percent (figure based on data provided by the World Bank) and although the economy was affected by the global financial crisis, Indonesia was one of the few G20 countries with a growing economy. Indonesia's GNI per capita has reached US\$2,580 (a lower middle-income country) in 2010 (figure according to the World Bank), and the middle class is growing and eager to consume. Furthermore there is the hope that private demand is joined by public expenditure. The government of President Susilo Bambang Yudhoyono plans to add 15,000 megawatts of power generation and to construct 20,000 kilometres of motorways by 2014.²⁸ It remains to be seen if these figures can be realized, but certainly investment in infrastructure is needed to foster further growth.

²⁴ World Bank/International Financial Cooperation, *Doing Business 2011: Making a Difference for Entrepreneurs*, (Washington: IBRD/World Bank), 2.

²⁵ Transparency International, „Corruption Perception Index 2010,“ http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results (accessed 09 December 2011).

²⁶ Business Area, "The European Union plans to increase investment in Indonesia", 31 March 2011.

²⁷ Surface Area according to the Indonesian Foreign Ministry website (<http://www.kemlu.go.id/Pages/TipsOrIndonesiaGlanceDisplay.aspx?IDP=1&l=en>).

²⁸ Bloomberg News, "Indonesia Risks Losing Investor 'Sheen' as Economy Revamp Slows," 25 April 2011.

But Indonesia has more to offer than an emerging and dynamic market. The archipelagic state is rich in resources. According to data provided by the U.S. Energy Information Administration (EIA) Indonesia had as of January 2010 3.9 billion barrels of proven oil reserves, 106 trillion cubic feet of proven natural gas reserves and 5.5 billion short tons of recoverable coal reserves. While the country has become a net oil importer in 2004, it still is a leading exporter of Liquefied Natural Gas (LNG), fighting with Qatar over the title of world export champion, and is one of the top five coal exporters worldwide.²⁹ Other main natural resources are nickel, copper, gold (the world's largest gold mine is run in the Indonesian province Papua), and tin. In addition less significant deposits of bauxite and silver exist. In the tin sector only China produces more worldwide. In the output of copper and nickel Indonesia is among the world's top five, in the production of gold among the top ten.³⁰

Of special importance to Europe are agricultural products, since they form the biggest category – almost a third – of Indonesian exports to the EU in 2009. Animal and vegetable oils provided half of these exports, palm oil being the main commodity.³¹ Palm oil stands out, not only because it is used in many consumer products from soaps to candy bars, but because biodiesel can be produced out of it. That way palm oil becomes part of Europe's efforts to fight climate change. In this policy field the EU has set itself ambitious targets: By 2020 the EU wants to reduce emissions to 20 percent below 1990 levels and raise the share of renewable in its energy mix to 20 percent. In the transport sector the target is to increase the share of biofuels to 10 percent.

Although the EU and its member states support the cultivation of biofuel crops it is unlikely that the demand for them can be met by domestic cultivation alone. Indonesia on the other hand is one of the leading producers of palm oil worldwide. A perfect match of interests then? Not quite, says an international coalition of civil society

²⁹ Energy Information Administration, "Country Analysis Briefs: Indonesia," last update 25 May 2011, <http://www.eia.gov/EME/cabs/Indonesia/pdf.pdf> (accessed 09 December 2011).

³⁰ Chin S. Kuo, "Indonesia," in U.S. Geological Survey, *2009 Minerals Yearbook*, (Washington: USGS), 12.1-12.9. It should also be added that Indonesia has uranium reserves.

³¹ EU Delegation to Indonesia and Brunei Darussalam, "Trade Flows", http://eeas.europa.eu/delegations/indonesia/eu_indonesia/trade_relation/trade_flows/index_en.htm (accessed 09 December 2011).

groups, which has put the sociological and ecological costs - mainly the destruction of rainforest for palm oil plantations - on the agenda of the debate.³² Indonesia, on the other hand, disputes that its palm oil production leads to deforestation.³³ Nevertheless, the EU reacted to the criticism by civil society and is currently reconsidering its general biofuel policies. There might be not a boom for palm oil after all.

The issue of palm oil therefore reflects the general picture of economic relations between Europe and Indonesia quite well. There is already much interaction between the two entities, the EU is for example Indonesia's fourth largest trade partner, but there is the potential for much more. Considering the size of Indonesia place 32 on the EU's list of major trading partners should not be the end of the story.

Diplomatic Interests

It is widely accepted that global problems such as climate change, pandemic diseases or migration cannot be solved by a single nation state alone. In a globalized world, with states, markets and societies more and more interdependent, global solutions are needed. In other words, there is a need for global governance. The EU envisions itself playing a leading role in this management of globalization, but is also aware that it needs global partners. Indonesia on the other hand takes pride in an active and independent (*bebas dan aktif*) foreign policy and has played in the past decades a prominent role in international affairs in various contexts, not least within the Nonaligned Movement and the Association of Southeast Asian Nations (ASEAN). Jakarta is still a key player in ASEAN and furthermore a member of the G-20. It is fair to say, that European and Indonesian diplomatic ambitions meet.

While there are many issues where Jakarta and Brussels could benefit from diplomatic cooperation, some stand out. The relevance of Indonesia for the interfaith-dialogue has already been mentioned. Clearly the European Union can profit from a moderate voice in the global discourse on religious affairs. Not only on the war on terrorism

³² Oliver Pye, "Nachhaltige Profitmaximierung: Der Palmöl-Industrielle Komplex und die Debatte über nachhaltige Biotreibstoffe," *Peripherie*, No. 112 (2008), 429-455.

³³ Indeed, the EU and Indonesia signed a trade accord on timber (a so called FLEGT-VPA) in spring 2011, whereby timber certified by Indonesia's national authorities will be regarded as legal by the EU.

but on other issues regarding the place of religion in political affairs in general. Another issue is the fight against pandemic diseases. According to data from the World Health Organization no country has suffered more deaths from avian influenza so far than Indonesia.³⁴ In Europe an outbreak of bird flu among wild birds alarmed the public in 2006, leading to demands of enhanced international cooperation in this field. The PCA between Brussels and Jakarta indeed acknowledges a mutual interest in health issues and calls for a strengthening of activities in this area, specifically mentioning the avian influenza.

More prominent on the diplomatic agenda are at the moment however two other issues: climate change and the global financial crisis. It is hard to overstate the importance of Indonesia for the ecological future of the planet. On the one hand no other country is richer in biological diversity of plant and animal life. Its territorial waters are home to the highest marine diversity worldwide and its islands host the second largest area of rainforest. On the other hand Indonesia is, because of forest fires and environmental degradation, the third largest emitter of greenhouse gases worldwide.³⁵ The EU, eager to present itself at the forefront in the fight against climate change, needs Indonesia in order to make progress in this struggle.

And the Southeast Asian state is willing to take an international leadership role in environmental affairs, despite some domestic opposition. Indonesia has been a signatory state of the Kyoto Protocol and hosted the 13th Conference of the Parties to the United Nations Framework Convention on Climate Change in 2007. At the follow-up conferences in Copenhagen 2009 and Cancun 2010 Indonesia made it heard as voice of the developing nations, pushing with success for funds to help developing nations to mitigate the effects of global warming.

Europe's search for partners in global governance is at the moment most obvious however not in the field of ecological but economic problems. The global financial crisis which started in 2008 has had tremendous effects on Europe. What first had been a problem for several

³⁴ World Health Organization, "Avian Influenza: Cumulative Number of Confirmed Human Cases as of August 19, 2011," <http://www.globalhealthfacts.org/data/topic/map.aspx?ind=32> (accessed 09. December 2011).

³⁵ Mariah Measy, "Indonesia: A Vulnerable Country in the face of Climate Change," *Global Majority E-Journal*, Vol. 1, No. 1 (2010), 31-45.

national economies (Ireland, Portugal, Spain, and Greece), now has become a crisis of the Euro, the common currency of 17 EU member states. For the EU this is not only an economic but also a political crisis, testing the solidarity between its member states. In the words of German Chancellor Angela Merkel: "When the Euro fails, Europe fails".³⁶ As the involvement of the International Monetary Fund in the rescue attempts for Greece has shown, the EU relies on the international community for help to solve its financial problems.

Indonesia is in this context of relevance because it is a member of the G-20. This forum, which started as a meeting of finance ministers to discuss issues of international finance, is more and more seen as replacing the G-8 as the main global decision-centre in economic affairs. In this new arrangement developing countries like Indonesia have gained status and power.³⁷ Europe, represented in the G20 by France, Germany, Italy, the United Kingdom and the European Union, is therefore well advised to reach out to developing nations, including Indonesia, if it wants to shape the international economic structure according to its interests and values. Indeed, José Manuel Barroso, president of the European Commission, and Herrman van Rompuy, president of the European Council, met with Indonesia's president Yudhoyono on the sidelines of the G20 Summit in Cannes on November 4, 2011.

Last but not least Indonesia is a key player in ASEAN. In this context no external actor in the region between the Indian and Pacific Ocean can ignore Southeast Asia's biggest nation. But for the EU there are special incentives to canvass Jakarta that differ from those of nation states. The EU sees itself as a future model for cooperation and is as such eager to promote regional cooperation elsewhere. Compared to other regional organizations, such as the Southern Common Market (MERCOSUR) or the Shanghai Cooperation Organisation (SCO), ASEAN seems to be the most mature on the global stage. So Brussels is more than willing to help Southeast Asia to progress on its way to

³⁶ Angela Merkel made this statement during her speech in the German Parliament, 26 October 2011. The German transcript can be retrieved under: <http://dipbt.bundestag.de/dip21/btp/17/17135.pdf#P.15949> (accessed 09 December 2011).

³⁷ Jusuf Wanandi and Maria M. Wihardja, "G20: East Asian-Pacific Perspectives," *The Indonesian Quarterly*, Vol. 38, No. 2 (2010), 213-221.

further integration.³⁸ Without the support of Indonesia, however, any European hopes of further institutionalization of ASEAN are futile.

Another consequence of the EU's identity as a regional organization is its emphasis on intra-regionalism. Since the first conference the foreign ministers of the members of the EC and ASEAN in 1978, ASEAN has been a cornerstone of the intra-regional dialogue between the two continents. However, in recent years the Asia-Europe Meeting (ASEM) has grown into the most important interregional forum, reducing the relative weight of ASEAN for Brussels. On the other hand, the ASEAN Regional Forum (ARF) at which the EU participates remains the most relevant multilateral security institution in Asia-Pacific. And the EU would like to join the East Asia Summit, another forum with ASEAN in leadership position. Thus, as long as ASEAN remains at the core of the institutional architecture of the wider Asian region, the organization, and with it its central player Indonesia, remains a valuable dialogue partner for the EU.

Conclusion

The EU has a lot to gain from closer partnership with Indonesia. Sheer geographic and demographic size, combined with ample natural resources and strategic location puts Indonesia firmly on the geopolitical map. In the realm of security Jakarta plays a vital part in the global fight against transnational threats such as terrorism and piracy. Other global challenges such as climate change and pandemic diseases demand the cooperation of Indonesia as well. With a cheap work force and a growing market the archipelagic state is an attractive place to invest and to do business with. Added to these factors, there is the political weight of Jakarta that results from the unique triple identity of Indonesia as being Asian, Muslim and developing. As key player in ASEAN it furthermore occupies an important place in the institutional structure of European-Asian relations. And on top of all these assets, Indonesia is, despite some weaknesses, a democracy with a pluralistic society.

³⁸ David Camroux, "The Political and Economic Dimensions of EU-ASEAN Relations: An Overview," in José Luis Sales Marquez, Reimund Seidelmann and Andreas Vasilache, ed., *Asia and Europe: Dynamics of Inter- and Intra-Regional Dialogues*, (Baden-Baden: Nomos, 2009), 184.

The list of reasons for deeper and wider engagement with Indonesia is long. But one aspect has not been mentioned yet: The need to counterweight the increasing dependency of Europe's economies on China. For Europe it is not about containing the People's Republic in security terms, this is not seriously discussed in the EU, but to have a back-up plan should China run into domestic problems. Japan and South Korea will play a part in this diversification strategy for some time to come, but their population is aging, and the economic relations between India and Europe are still in their infancy. Indonesia with her growing middle class and huge domestic market is the obvious alternative. The challenge in the near future is to put ballast on the European-Indonesian relationship, so that potential interests become vested interests.

Islam and Party Politics in Indonesia: An Assessment of the 2009 Election¹

*Geoffrey P. Macdonald*²

Introduction

Indonesia is viewed internationally an exemplar of moderate Islamic politics. As the world's largest Muslim nation, its politics stand in stark contrast to Saudi Arabia or Iran, where Islamic strictures dominate both the political system and the everyday life of citizens. Islam in Indonesia is syncretic—layered over diverse ethnic, cultural, tribal, and religious traditions—making a totalizing Islamic state difficult to enact. Nevertheless, Indonesia's public policy has become increasingly conservative. New laws mandate Islamic instruction in schools and restrict access to and production of pornographic materials. Discrimination persists against Christians and splinter Islamic sects with little reprimand from political elites. This has led some Indonesia scholars to argue that Indonesians and their political representatives are increasingly abandoning the secular foundation of the post-colonial Indonesian state. To test this thesis, this paper conducts a content analysis of the 2009 parliamentary and presidential campaigns, focusing specifically on the role of Islamic rhetoric used by political parties to mobilize voters. It finds that Indonesian parties in fact continue to use secular appeals despite their pursuit of conservative legislation when governing. Additionally, it shows that parties' election appeals are vir-

¹ This paper is based on ongoing research being conducted for a Ph.D. dissertation, which compares identity politics in Indonesia, South Africa, and India.

² Geoffrey Macdonald is a Ph.D. Candidate at the Josef Korbel School of International Studies at the University of Denver and was a Visiting Fellow at the Centre for Strategic and International Studies in Jakarta.

tually indistinguishable, which undermines the quality of Indonesian democracy. The paper proceeds as follows: it first outlines the current debate regarding Indonesian political behavior; next, it analyzes the 2009 election, assessing the issues discussed during debates and on the campaign trail; finally, it operationalizes an existing typology of Indonesian political parties, locating parties along a spectrum of "Islamism" according to their campaign rhetoric.

Islam and Indonesian Politics

The role of Islam in Indonesian politics has received much attention in the post-Suharto era. Long suppressed by rigid and rigged election rules during decades of authoritarianism, Islamic parties have proliferated since 1998. However, their actual influence in Indonesian politics is debatable. The 2009 parliamentary elections gave seats to four Islamic parties in the People's Representative Council (DPR): the Prosperous Justice Party (PKS), the National Mandate Party (PAN), the United Development Party (PPP), and the National Awakening Party (PKB). Yet these parties won only 24.1 percent of the vote combined and none gained more than 7.9 percent.³ Moreover, the 2009 results still show a steady decline in support for Islamic parties across elections. In 1955, Islamic parties received 44 percent of the vote. By 1999, their support was down to 36.3 percent. After a small increase in 2004, the overall support for Islamic parties, including those that did not win parliamentary seats, was down to 29.2 percent in 2009.

Dovetailing this decline in support is the apparent rationalization of Indonesian voters. Questioning the importance of identity-based politics in Indonesia, Saiful Mujani and R. William Liddle argue that "the democracy that is being consolidated in Indonesia is a secular democracy in which Muslim parties of all kinds...have lost support to fully secular parties."⁴ Their explanation is that voters now use economic concerns and party platforms rather than religious identity to decide between candidates. This combines with the syncretic Muslim

³ Rizal Sukma, "Indonesia's 2009 Elections: Defective System, Resilient Democracy," in Edward Aspinall and Marcus Mietzner, eds., *Problems of Democratisation in Indonesia* (Singapore: Institute of Southeast Asia Studies, 2010), 56.

⁴ Saiful Mujani and R. William Liddle, "Muslim Indonesia's Secular Democracy," *Asian Survey* 49, 4 (2009), 577.

identity in Indonesia that is incompatible with strict Islamic tenets, they argue. Mujani and Liddle find that 57 percent of Indonesian voters are secular, concluding that “secular political parties and secular politicians now dominate Indonesian politics and look set to do so for the foreseeable future.”⁵ Thus, in the battle between Islamism and secularism in Indonesia, secular politics has won.

However, some Indonesia scholars reject this secular versus Islamic dichotomy in Indonesian politics as well as the apparent decline in Islam’s political salience. Anies Rasyid Baswedan claims that mainstream Indonesian parties do not fall easily into this two-part typology. He argues that a conditioning descriptor of either inclusive or exclusive should be added, creating four party types out of the previous two: secular-exclusive, secular-inclusive, Islam-exclusive, and Islamist.⁶ This is necessary, he contends, because of the often-mixed images presented by parties. Nominally Islamic parties, such as PAN and PKB, oppose hard-line Islamic positions even while catering to Muslim voters and organizations. Conversely, Golkar—generally considered a secular-nationalist party—has taken Islam-friendly positions on controversial issues, such as the 2003 education bill that effectively mandated Islamic instruction in Christian schools.⁷ Sunny Tanuwidjaja argues that “the so-called nationalist parties, or parties proclaiming *Pancasila* as their party’s foundation, also support an Islamic agenda.”⁸ Indeed, the supposedly secular Democrat Party (PD) spearheaded the conservative anti-pornography law and mainstream parties have responded to the persecution of the “heretical” Ahmadiyah sect with virtual silence. This evidence combines with surveys showing strong support for Shariah among Indonesians.⁹ This school of scholars rejects the “rational voter” thesis of Mujani and Liddle, arguing that Islam and identity still play a major role in Indonesian politics.

These competing views of Indonesia’s political trajectory—rationalization versus Islamization—are built upon survey data and, in the

⁵ Mujani and Liddle, “Muslim Indonesia’s Secular Democracy,” 590.

⁶ Anies Rasyid Baswedan, “Political Islam in Indonesia: Present and Future Trajectory,” *Asian Survey* 44, 5 (September/October 2004), 669–690.

⁷ Baswedan, “Political Islam in Indonesia: Present and Future Trajectory,” 677.

⁸ Sunny Tanuwidjaja, “Political Islam and Islamic Parties in Indonesia: Critically Assessing the Evidence of Islam’s Political Decline,” *Contemporary Southeast Asia*, 32, 1 (2010), 40.

⁹ However, the specific tenets of Shariah receive much less support than Shariah in general.

case of the latter view, specific legislative decisions. Yet this focus on voter surveys, policies, and election outcomes ignores a crucial element of the political process: election campaigns. Campaigns provide the most direct interaction between political elites and voters. Parties and their candidates will emphasize the issues most likely to maximize their chances of victory. Thus, an analysis of Indonesian parties' voter mobilization strategies will elucidate the political importance of Islam. Do parties emphasize Islamic principles and Shariah law while campaigning? Or do they promote pluralism and a secular policy agenda to reach voters? The following section presents a content analysis of the 2009 parliamentary and presidential election campaigns, focusing specifically on the issues raised by political parties.

The 2009 Election

Thirty-eight political parties competed for seats in the DPR during Indonesia's 2009 parliamentary election. Election rules require all parties to demonstrate a nation-wide organizational presence, thus precluding local parties in all provinces except previously separatist Aceh, which received special status after the 2005 Helsinki Memorandum of Understanding. After the April 9th vote, the three best performing parties were secular-nationalist: PD (20.9 percent), Golkar (14.5 percent), and the Indonesian Democratic Party-Struggle (PDIP) (14.3 percent). As noted above, no Islamic party won greater than 7.9 percent of the vote. Held several months later, direct presidential elections require candidates to be nominated by parties with at least 20 percent of the DPR seats or 25 percent of the national vote. This forces small parties to form election coalitions with larger parties and limits the number of competing candidates. In 2009, three candidates represented their party's election coalitions: Susilo Bambang Yudhoyono (often called SBY) of PD, Megawati Sukarnoputri of PDIP, and Jusuf Kalla of Golkar. On July 8th, incumbent President SBY won in a landslide with 60.8 percent of the vote, obviating the need for a second-round runoff election.

Content Analysis of the Parliamentary and Presidential Campaigns

In order to assess the election strategies of both successful and unsuccessful parties, a content analysis of the parliamentary and presidential campaigns was conducted. For each campaign period, cam-

campaign statements were compiled using newspaper coverage of rallies, speeches, public statements, and interviews. Campaign statements are those made by a party official or candidate to convince a voter to support his or her party and/or not support another party. Each statement contains one or more issues (e.g., better healthcare, more defense spending, or Shariah law) designed to appeal to voters. For each campaign, part of the closed campaign period and all of the open campaign period was analyzed. In sum, 390 issue statements were compiled (173 from the parliamentary campaign and 217 from the presidential campaign). The coding includes statements from twenty-eight parties during the parliamentary election and all three competing tickets during the presidential election.¹⁰ In addition, the debates between presidential and vice-presidential candidates were analyzed. Though not included in the quantitative content analysis, the debates were used to assess the policy and ideological differences between parties in a closed forum.

Debate and Platform Analysis

The presidential and vice-presidential candidates held a series of debates in the weeks prior to the election.¹¹ Presidential candidates Megawati, Kalla, and incumbent President SBY held three debates on separate topics: 1) good government, legal enforcement, and human rights; 2) poverty and unemployment; and 3) democracy, regional autonomy, and the unitary state. Vice-presidential candidates Boediono, Wiranto, and Prabowo Subianto debated two topics: 1) building a national character; and 2) raising Indonesia's standard of living. The opening statements made during these debates constitute the clearest announcement of each party's ideological and policy platform.¹² Within each debate theme, the candidates first outlined their party's core ob-

¹⁰ The period of March 13, 2009 - April 5, 2009 (the parliamentary campaign) and June 2, 2009 - July 4, 2009 (the presidential campaign) was analyzed using the Jakarta Post online search feature. The terms "election" and "rally" were searched. This yielded several hundred relevant articles, from which campaign statements were extracted and coded. The resulting database of campaign statements includes statements made in twenty-five of Indonesia's thirty-three provinces, spanning from Aceh to Papua. Using the Jakarta Post as the sole source presents limitations, but its political coverage is considered the most extensive of all Indonesian newspapers and its content is often cited in academic literature on Indonesian and Southeast Asian politics.

¹¹ Debate transcripts are available through the Jakarta Post website.

¹² The parties do not publish conventional election manifestos that clearly outline their policy platforms.

jectives and orientation toward the issue. Next, they were questioned on sub-issues within the theme, allowing each candidate to advocate his or her specific position. This section first analyzes the candidates' opening statements, which represented the party's general policy agenda toward each theme; then it analyzes the exchange between candidates on each sub-issue, during which each party's position could be clearly differentiated. However, as will be shown, there was little substantive difference between the candidates during either their opening statements or direct exchanges.

During the course of the debates' opening statements, each set of candidates laid out their party's platform for the campaign. Representing PDIP, Megawati and Prabowo emphasized Indonesia's nationalist leaders and the 1945 Constitution. "We have to realize our founding fathers' goal of building the country with good governance and law enforcement," Megawati said during the first debate. Good governance, she claimed, had five aspects: serving the people, protecting the people, reforming the bureaucracy, raising civil servant salaries to prevent corruption, and improving the capability of civil servants. In a later debate, Megawati extolled Sukarno, Muhammad Hatta, and the founding ideology of Pancasila. The PDIP team often espoused economic populism. Prabowo emphasized the party's "people's economy programs" designed to ensure a more equal distribution of wealth and to "return the power of the economy to the hands of the Indonesian people." In the second vice-presidential debate, Prabowo called for an increased governmental role in poverty alleviation, including the provision of food, clothing, shelter, health services, clean water, and free education to Indonesians.

Representing the ruling Democratic Party, SBY and Boediono, praised the preceding five years of government performance while also acknowledging the need for reform during their opening statements. "We must continue to reform our bureaucracy" to build good governance, SBY claimed, without which corruption, collusion, nepotism, and poor service delivery would expand and the business climate and national pride would suffer. During the first debate, SBY recognized the need to "uphold human rights" and bolster law enforcement. In the first vice-presidential debate, Boediono argued that "clean government is the key to build the nation's character," which he defined as national

culture, politics, economy, and law. SBY praised his administration's stewardship of the Indonesian economy during the global economic crisis as well as government intervention programs, such as direct cash aid and rice distribution, which had reduced poverty. In order to raise Indonesian's standard of living, Boediono called for an expansion of free education and healthcare and called upon families to have less children. On the topic of democracy and the state, SBY praised the role of Pancasila and the reformasi movement, but admitted the need for changes to the administration of regional autonomy.

Jusuf Kalla and Wiranto, representing Golkar, emphasized similar themes during their opening statements. Kalla called for a salary increase for civil servants, improved service delivery, and a strong role for government in social issues. The government, he argued, was the "motor" of programs designed to create a "prosperous and just country." Wiranto claimed that Indonesia "did not know" itself and needed to build its "soul" and "body" to strengthen its national character. Kalla argued that he would defend national unity and emphasized his role in negotiating the end of regional conflicts in Aceh and Ambon. Regarding economic suffering, Kalla argued that poverty was due to a lack of education and access to financing. He called for better infrastructure, the development of agriculture, and the pursuit of 8 percent economic growth. Kalla supported regional autonomy, but argued that "there are still many weaknesses, and we have to ensure that each region can take care of itself." Wiranto summed up the pair's mission "to establish a country of equality, competitiveness, independence, and dignity."

To the extent that these opening statements were not interchangeable, there was in fact little mention of any policy or agenda with which any candidate would have disagreed. Better service delivery, more access to education, a stronger economy, helping farmers, and creating prosperity are uncontroversial issues supported by all Indonesians. Additionally, each candidate stood against corruption and envisioned a strong role for central government in addressing the pervasive issues of poverty and underdevelopment. In sum, these pre-written opening statements failed to showcase any clear difference between parties or demonstrate a substantive policy approach to important issues.

During the actual debate exchanges, the candidates did little more to distinguish their policy positions. In five televised interactions, the

candidates rarely disagreed and often expressed unqualified agreement with the opinions of their competitors. Even when not explicitly agreeing with one another, there was little substantive difference between most of their answers. Of the thirty questions asked during the debates (six per debate), twenty-three of the candidates' answers were either the same or variations of the same answer. There was general agreement on a broad array of issues, including expanding the military budget, addressing corruption, protecting migrant workers, aiding Lapindo flood victims, preserving human rights, reducing conflict, preventing future transit accidents, strengthening education, reinforcing Pancasila, helping farmers, expanding fuel subsidies, improving election administration, promoting regional autonomy, and enhancing national unity.

When the candidates did disagree, it was more a matter of degree than of substance. On the issue of encouraging investment in labor-intensive businesses, they disagreed whether it was the investment law or the labor law that needed reform. In addressing the budget deficit, Megawati emphasized economic independence, Kalla sought to make the state more efficient, and SBY wanted to delay privatization. Both Kalla and Megawati advocated reform of the outsourcing law, while SBY believed "we should not be in a hurry to revise the law." There was modest disagreement over the feasibility of universal healthcare (though not regarding its necessity), the balance between funding for vocational and general schools, and the effectiveness of family planning regulations (though not regarding the need to curb population growth).

The vice-presidential candidates voiced a subtle difference in their view on the role of religion and the state. Boediono argued that "religion is so noble; it should not be used as a political element." Prabowo, agreeing with Boediono, said "religion must be placed above politics and the state must ensure freedom to embrace religion." However, Wiranto, chastising Boediono directly, contended that "religious values should be implemented to build political ethics. We must have morality in politics." The paucity of direct references to Islam during these debates is striking. Only Boediono briefly mentioned the importance of Islamic schools during the second vice-presidential debate.

Despite mild disagreement, the debates did little to clarify each party's platform or distinguish the political choices available to voters. Press coverage of the debates emphasized this point. A political observer described the first debate as "mediocre" during which "the three candidates did their best to agree and when it came to areas where the three had differences, they did their best to gloss over them with banalities."¹³ Moreover, candidates preferred "to agree with their rivals' remarks rather than propose concrete solutions."¹⁴ Where there was disagreement, it was described as "warm" and ultimately "timid."¹⁵ During the vice-presidential debate, the ideologically similar candidates were described as "three yins with no yang."¹⁶ A moderator of one of the debates claimed afterwards that the candidates "failed to highlight and target clear agendas for the future of the country. Some of their policies also contradicted previous statements."¹⁷ While the debates did represent the clearest exposition of each party's platform, these turned out to be mostly interchangeable and equally platitudinous.

The Issues Discussed on the Campaign Trail

Outside of the debate format, Indonesian political parties discussed a wide range of issues on the campaign trail (Figure 1). From the 390 issue statements culled during this analysis, thirty-four distinct topics were deciphered,¹⁸ ranging from national unity and Sharia law to the environment and human rights. Issues relating to the economy and development were the most discussed during both the parliamentary (21.4 percent) and presidential (25.3 percent) campaigns. However, these issues constituted only a small plurality of the two campaigns' rhetoric. During the parliamentary campaign, no other issue made up

¹³ Wimar Witoelar, "Mediocre in content, the presidential debate is historic," *The Jakarta Post*, June 19, 2009

¹⁴ Erwida Maulia, "Online Special Feature: Interactive Debate Coverage," *The Jakarta Post*, June 19, 2009

¹⁵ Erwida Maulisa, "More jokes, but still a timid second-round debate," *The Jakarta Post*, June 26, 2009

¹⁶ Meidyatama Suryodiningrat, "A speech, a lecture, and a song from all the president's men," *The Jakarta Post*, June 24, 2009

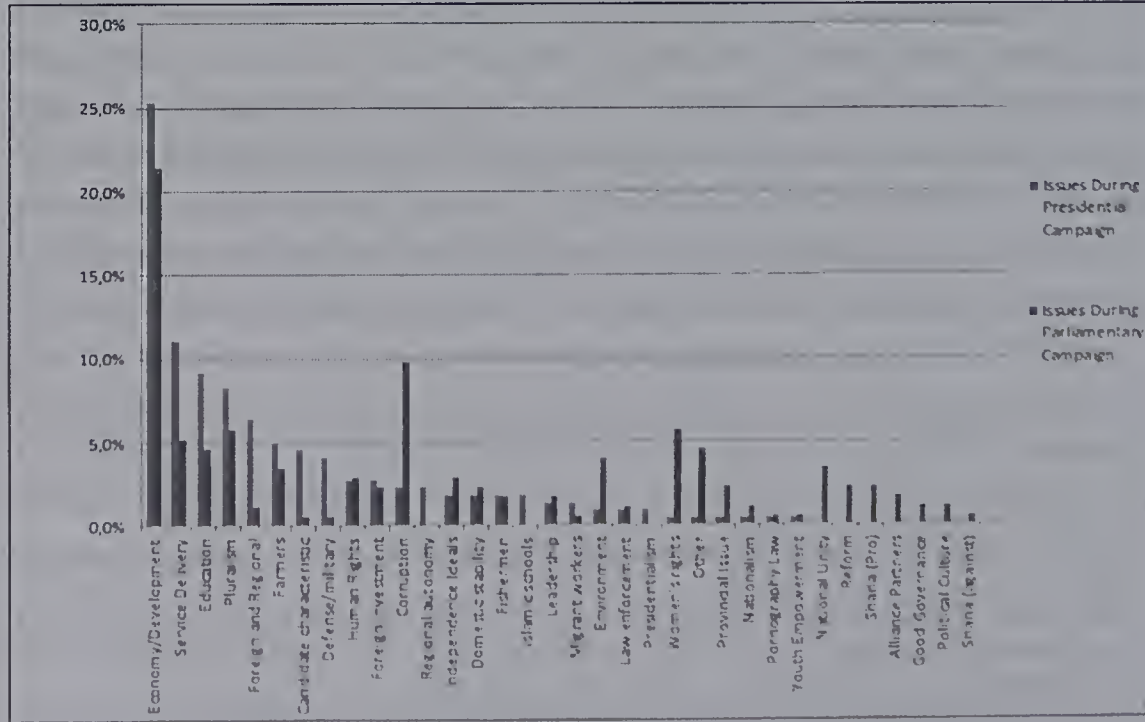
¹⁷ "Candidates sidestep tough questions," *The Jakarta Post*, June 27, 2009

¹⁸ This includes an 'Other' category comprised of topics that appeared only once in the sample from both the presidential and parliamentary campaigns.

more than 10 percent of the discussion. Statements regarding corruption (9.8 percent), pluralism (5.8 percent), women’s rights (5.8 percent), service delivery (5.2 percent), and education (4.6 percent) were the next five most common in the sample. The twenty-eight remaining topics each made up less than 4.6 percent of the statements, but together constituted 47.4 percent of the overall parliamentary rhetoric.

The presidential campaign did not differ dramatically in rhetorical content. After issues regarding the economy and development, the next three most discussed topics in the sample were: service delivery (11.1 percent), education (9.2 percent), and pluralism (8.3 percent). The fifth most discussed topic was one that received comparatively less attention during the parliamentary campaign: foreign and regional policy (6.5 percent). There were twenty-eight distinctive topics raised during the presidential campaign, six fewer than during the parliamentary campaign. The top five topics constituted 60.4 percent of the overall rhetoric. The remaining 39.6 percent of the rhetoric revolved around twenty-five other topics, none of which constituted more than 5.1 percent of the campaign statements.

Figure 1. Topics During the Presidential and Parliamentary Campaigns



The wide range of issues discussed during the both campaigns by all parties indicates the absence of a disciplined message strategy. With no succinct and focused platform to provide a core ideological and policy orientation, candidates appeared to employ whatever rhetoric they thought would mollify the audience they stood before. At various times and locations, the candidates' promises targeted fisherman, teachers, farmers, women, youth, activists, nationalists, and others. Moreover, as will be shown below, the parties' promises were often indistinguishable. Voters were thus left with little way of understanding not only the differences between parties, but also what the important issues facing the nation actually were.

Economic populism dominated the rhetoric on the economy and development. Campaigning on behalf of the Democratic Party in Yogyakarta, SBY emphasized the party's "pro-people development programs" including cash aid and unemployment alleviation.¹⁹ A PAN official promised to "give every village in Indonesia a Rp 1.5 billion annual budget to support development projects."²⁰ Gerindra candidates promised to enhance "the people's access to natural resources"²¹ and create economic empowerment through regional autonomy.²² Prabowo Subianto claimed Gerindra was "determined to develop a people-oriented economy to empower low-income people, mainly farmers, fishermen and teachers."²³ Speaking on behalf of PDIP, Megawati said that under SBY's leadership unemployment and poverty had increased and economic development had stagnated.²⁴ Other parties, including Hanura, the Sovereign Party, the Labor Party, and Aceh-based parties, called for more jobs and critiqued the foreign domination of resources.

Corruption, women's rights, and education were also common issues during the parliamentary campaign. Virtually all parties made some claim to transparent leadership. Rama Pratama of PKS claimed the party was "clean" and free of corruption.²⁵ Prabowo said there was

¹⁹ "Campaign season to wrap up today," *The Jakarta Post*, April 5, 2009

²⁰ "PKS has Jakarta seeing white, as others pile on the promises," *The Jakarta Post*, March 31, 2009

²¹ "Parties lack commitment to environmental protection," *The Jakarta Post*, April 4, 2009

²² "Election frenzy hits ethnic Papuan elites," *The Jakarta Post*, March 20, 2009

²³ "PKB mass gathers support for Gerindra, Prabowo," *The Jakarta Post*, March 16, 2009

²⁴ "Campaign season to wrap up today," *The Jakarta Post*, April 5, 2009

²⁵ "PKS has Jakarta seeing white, as others pile on the promises," *The Jakarta Post*, March 31, 2009

no "corruption, collusion, or nepotism" in Gerindra."²⁶ Megawati critiqued the Democrats' and SBY's cash-aid program as an abuse of state resources.²⁷ During a campaign stop in East Java, local candidates competed over the women's vote: a Golkar candidate said she would "ensure pro-women budgeting;" a PD candidate called for gender equality in the economy; and a PKS candidate promoted greater social justice for women.²⁸ In Bali, a Gerindra candidate said Indonesians needed to fight discrimination against women."²⁹ On education, Golkar,³⁰ PPP,³¹ and the Aceh People's Party³² all called for free education. The candidates also discussed domestic stability, environmental protection, aid to farmers and fishermen, foreign investment, migrant workers, and human rights among many others.

While the presidential campaign raised many of the same issues as the parliamentary campaign, the presidential candidates emphasized two unique issues: military spending and foreign policy. However, their positions on these issues were identical. Kalla promised to double the defense budget.³³ Megawati said she would make defense spending 20 percent of the budget in order to modernize military equipment.³⁴ SBY followed suit with general calls to increase the defense budget. On foreign policy issues, all three candidates emphasized a strong and independent Indonesia. A spokesman for Kalla said the candidate was committed to "rebuilding Indonesia's leadership in the Association of Southeast Asian Nations" and making Indonesia the foremost nation in the region.³⁵ The Megawati campaign said it would "proactively safeguard the country's sovereignty" and was against all neocolonialism.³⁶ SBY's team stressed the pursuit of a "free and active" foreign policy.³⁷ Beyond these two topics, echoes of the parliamentary

²⁶ "Students rejects Prabowo's presence in South Sumatra," *The Jakarta Post*, April 2, 2009

²⁷ "SBY counters Megawati's criticisms of cash aid," *The Jakarta Post*, March 29, 2009

²⁸ "The unexpected face of Indonesian politics," *The Jakarta Post*, March 30, 2009

²⁹ "Gerindra promises special status for Bali," *The Jakarta Post*, April 6, 2009

³⁰ "Kalla: Golkar to continue Soeharto's ideals," *The Jakarta Post*, April 4, 2009

³¹ "SBY pledges peace in Aceh, Mega calls for ballot punch," *The Jakarta Post*, March 30, 2009

³² Education, employment major issues for PRA," *The Jakarta Post*, April 3, 2009

³³ "Raise budget, build military industry, Kalla team," *The Jakarta Post*, June 6, 2009

³⁴ "Megawati offers huge defense budget hike," *The Jakarta Post*, June 5, 2009

³⁵ "Presidential hopefuls outline foreign policy," *The Jakarta Post*, June 4, 2009

³⁶ *Ibid.*

³⁷ *Ibid.*

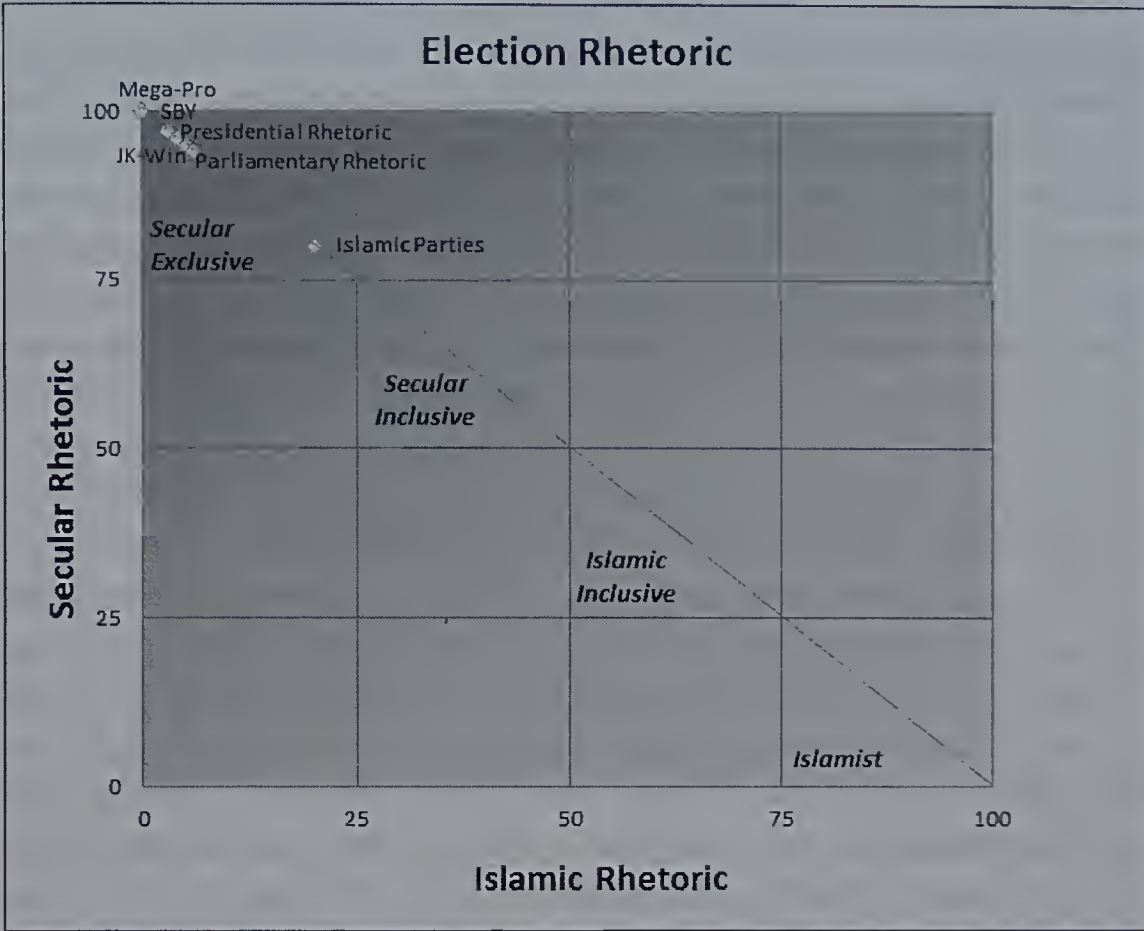
campaign were clear: Claims of being pro-education, anti-corruption, and pro-human rights were frequent.

This brief outline of parliamentary and presidential rhetoric shows that parties did little to differentiate themselves in either campaign. Candidates and spokespersons from the main contenders—PDIP, Golkar, and PD—overwhelmingly emphasized policy rhetoric, avoiding altogether any controversial issues, such as the Ahmadiyah sect or the pornography law, which could have alienated voters during the presidential campaign. Even on policy issues, the parties, both major and minor, promoted virtually identical and unobjectionable positions on education, national unity, corruption, domestic subsidies, and other topics.

Islamic versus Secular Rhetoric on the Campaign Trail

The previous section shows the wide array of topics addressed by parties while campaigning and suggests the predominant importance of non-religious issues to Indonesian voters. Now narrowing our focus to the political salience of religious identity, which is the foundation of Baswedan's typology of Indonesian parties, this section specifically evaluates the frequency of religious issues raised during the campaign. Figure 2 below quantifies Baswedan's party typology according to campaign statements during the 2009 election: Parties whose rhetoric is over 75 percent secular and less than 25 percent Islamic are considered secular exclusive; parties whose rhetoric is between 50 and 75 percent secular and 25 and 50 percent Islamic are considered secular inclusive; parties whose rhetoric is between 25 and 50 percent secular and 50 and 75 percent Islamic are considered Islam inclusive; and parties whose rhetoric is less than 25 percent secular and between 75 and 100 Islamic are considered Islamist. Rhetoric was considered "Islamic" if it explicitly promotes Islamic values, norms, or institutions. Rhetoric was considered "secular" if it explicitly promotes pluralism, religious diversity, or tolerance, addresses a purely policy-based issue, or opposes anti-secular legislation, such as Shariah law or the anti-pornography law.

Figure 2. Islamic versus Secular Rhetoric During the 2009 Election Campaigns



As Figure 2 shows, the rhetoric during the 2009 election campaigns was strongly secular. The issues raised by SBY/Boediono and Kalla/Wiranto were 97 percent and 95 percent secular respectively during the presidential campaign. The coding process did not find one Islamic issue raised by the traditionally secular Megawati and PDIP, making the party's rating 100 percent secular. Overall, 96 percent of the issues raised during the presidential campaign period were secular and only 4 percent targeted conservative Muslim voters. The parliamentary campaign featured marginally more Islamic rhetoric (6 percent). More surprisingly is that parties that are generally considered Islam-inclusive or Islamist also scored in the secular-exclusive category. Based on a sample of forty-five statements during the parliamentary campaign made by nine traditionally Islam-friendly parties (PAN, PPP, PKS, PBR, PKB, and four Aceh-based parties), only 20 percent of their rheto-

ric could be considered explicitly Islamic. Though a relatively small sample, it can be reasonably generalized that even traditionally religious parties emphasize secular issues while campaigning. Strikingly, according to the sample gathered, all major Indonesian parties should be considered secular-exclusive according to their election rhetoric. Below is a brief description of each party's Islamic rhetoric.

Democratic Party - The most transparent attempt by SBY/Boediono to reach out to Muslim voters was in fact reactive. A pamphlet distributed at a Kalla/Wiranto rally claimed Boediono's wife, whose name is Kristiani, was Christian. The campaign was quick to reassure voters that the claim was "slanderous." Additionally, SBY/Boediono called for additional funding to Islamic boarding schools. As shown in the above analysis, the candidacy's rhetoric was overwhelmingly secular and based on neutral policy issues.

PDIP - The coding procedure did not find one Islamic issue discussed by Megawati/Probowo during the presidential campaign. While some of these issues might not have received newspaper coverage, and were thus missed by the coding process, it is unlikely that even a full investigation of all of PDIP's election rhetoric would uncover much religious rhetoric. The party aggressively protects secular values and was the only party to oppose both the education bill and anti-pornography law.

Golkar - Presidential candidate Kalla had a strong support base among Muslim voters and made many trips to Islamic schools during the campaign. He and Wiranto emphasized the importance of Islamic schools in Indonesia and promised more support and funding if elected. Though the campaign denied culpability, the leaflets attacking Boediono were clearly an attempt by the campaign or its supporters to consolidate support among conservative Muslim voters.

Islamic Parties - The best performing Islamic party, PKS, emphasized the importance of Muslim unity and the need for its supporters to demonstrate its importance as an Islamic party. However, its rhetoric mostly focused on secular issues, e.g., opposing corruption, promoting pluralism, and spurring economic development. The PPP, while proclaiming a Muslim duty to support Islam and supporting a ban on Ahmadiyah, also promoted pluralism and human rights. Even Aceh-based parties, a province with a strong tradition of conservative

Islam, emphasized education, employment, development, and domestic stability while also advocating Shariah law.

Conclusion

The above analysis demonstrates a clear emphasis on non-religious issues by Indonesian political parties during election campaigns. During the legislative session, parties have taken contentious stances on issues such as the 2003 education bill, the 2008 anti-pornography law, or the rights of the Ahmadiyah sect. However, on the campaign trail, these issues are buried. Instead, campaigns are filled with oftentimes-vague policy prescriptions and vacuous rhetoric. Given the prominence of divisive religious, ethnic, and political issues in Indonesia, this rush to political safe ground is striking. Furthermore, the expansiveness and ideological unanimity of Indonesia's political debate is equally noteworthy. As the issue analysis above shows, the array of issues discussed during both the parliamentary and presidential campaigns is large. Thirty-four distinct topics arose, with each topic containing varying topic-specific issues. Yet on each of these issues, the parties maintained essentially identical positions. During the debates, candidates took great pains to agree with each other on most topics. Similarly, after analyzing their use of Islamic rhetoric, we find that all Indonesian political parties should be classified as secular-exclusive.

These ideologically empty political parties undermine the strength of Indonesia's democracy. Although receiving high marks from democracy institutes, such as Freedom House and Polity IV, the absence of significant competition during elections makes Indonesia a Potemkin democracy: impressive at first glance, but hallow upon further investigation. While possessing the mechanisms for vertical accountability (i.e., free and fair elections), parties do not provide different political options from which to choose. This gives voters little reason to hold a party accountable for its performance if its potential replacement is indistinguishable. Dan Slater convincingly describes Indonesia's party system as a cartel in which governing parties collude to control the resources of the state.³⁸ This paper's complementary analysis indicates

³⁸ Dan Slater, "Indonesia's Accountability Trap: Party Cartels and Presidential Power after Democratic Transition," *Indonesia* 78 (October 2004), 61-92.

a kind of political auto-tune during political campaigns, during which the pitch and tone of superficially competing parties is put into rhetorical harmony.

Moreover, this study has implications for the two competing explanations of Indonesian voter behavior: rationalization or Islamization. The concord of supposedly rival political parties severely restricts any rational assessment of their comparative fitness for leadership. A rational voter holds a rank order of issue preferences that he or she compares to each party's platform; whichever party's positions match closest the voter's preference order gets his or her vote. But with little way to differentiate between each candidate's positions, a voter cannot choose a party based on any "rational" or policy-based reasoning. Some other factor must be driving their vote. The Islamization school would tell us that parties are becoming increasingly conservative in order to appeal to devout Muslim voters. Yet the evidence challenges this as well. Despite the passage of conservative policies while governing, Indonesian parties do not campaign on these issues. Their focus is almost exclusively on non-religious policy issues. This raises an additional puzzle outside the scope of this paper: why do Indonesia's ruling secular parties pass conservative legislation and then marginalize these policies while campaigning? If these laws are part of an effort to bolster their conservative credentials, why not highlight them on the campaign trail? Regardless of its strategic logic, the above analysis clearly demonstrates the convergence of all major Indonesian parties on virtually identical positions, sapping elections of vibrant debate and potentially undermining the long-term health of Indonesia's democracy.

Outlook Remain Bright, Amid Turbulent Times

Deni Friawan

Overview

Indonesia's economic condition at the end of 2011 closed on a positive note. The inflation rate was low at below 4 percent and the economy is expected to grow strongly at 6.5 percent, the best performance since 1997/98 Asian financial crisis. Low public debt levels at only 26 percent of the nation's GDP and high foreign exchange reserves of more than US\$ 10 billion have continued to attract global investment in the Southeast Asia's largest economy, amid global economic woes. Nevertheless, Indonesia has not been totally immune from the impact of Euro zone debt crisis and the potential further weakening in global economic activity.

Global risk aversion triggered by Europe's debt problems continued to push offshore investors away from local assets, driving down Indonesia's stock market and rupiah. The country's benchmark stock index (IDX) closed 2011 up only by 3.2 percent, after rising by 12.5 percent from its initial level in January to its new all-time record of nearly 4,200 in early August. Similarly, the Indonesia rupiah has depreciated by 1 percent from its initial level at the beginning of the year, although it had appreciated by 6 percent in early August.

At the same time further slowdown in global growth prospects has resulted in a fall in external demand and commodity prices. Due to a decline in imports from the ailing US and Europe, Indonesia's monthly export growth has slowed since September 2011 by an average 3 percent, after recording the biggest export value in history at US\$ 18.6 billion in August. Furthermore, leading up to November, Indonesia's

monthly trade surplus also narrowed in recent months as growth of imports surpassed exports.

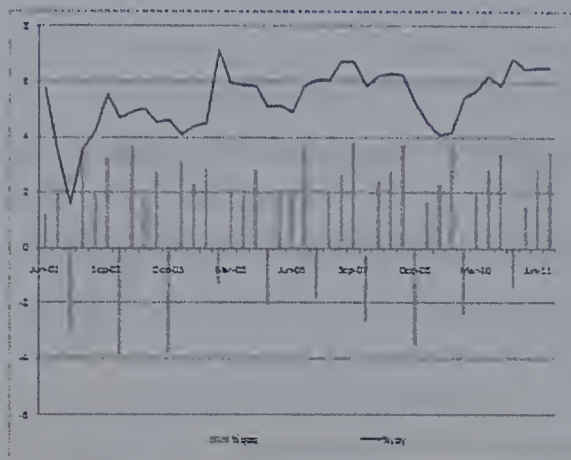
Looking ahead to 2012, the growth outlook is expected to remain bright, yet unexpected capital outflow reversal, slowing external demand, and lower commodity prices may lead to downside risks to this forecast. Indonesia GDP in 2012 is likely to grow at 6.3% to 6.7%, slightly down from projected GDP growth of 6.5 percent in 2011. The headline inflation would remain relatively benign at around 5 percent by the end of 2012 as slowing global growth weighs on commodity prices.

Nevertheless, the recent declines in commodity prices and portfolio flows to emerging markets, together with a deterioration in global demand, is expected to lead to a moderation of the balance of payment surplus. Moreover, sour global sentiment surrounding Europe debt crisis is expected to continue driving down Indonesia's stock market and rupiah for sometime in the short term, as Indonesia has high exposure to foreign funds in its bond and equity assets.

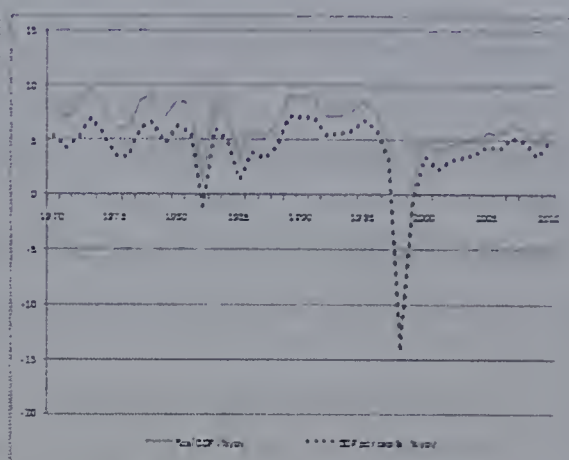
Economic Growth

Indonesia's economic growth in the first three quarters of 2011 remained robust, despite the uncertain global economic outlook. Quarterly GDP growth continued to increase from 1.6 percent in Q1-2011 to 2.9 percent in Q2-2011 and 3.5 percent in Q3-2011. Meanwhile, on a yearly basis real GDP grew by 6.5 percent for the third consecutive quarter. The real GDP growth in the fourth quarter is likely to be equivalent to its growth rate in the preceding quarters, bringing the full-year economic growth in 2011 to 6.5 percent. This potential growth rate is higher than the average growth rate in the last decade and the government growth target rate of 6.3 percent.

Figure 1a. Annual and Quarterly GDP **Figure 1b. Long run growth**



Source: CEIC Database



Source: CEIC Database

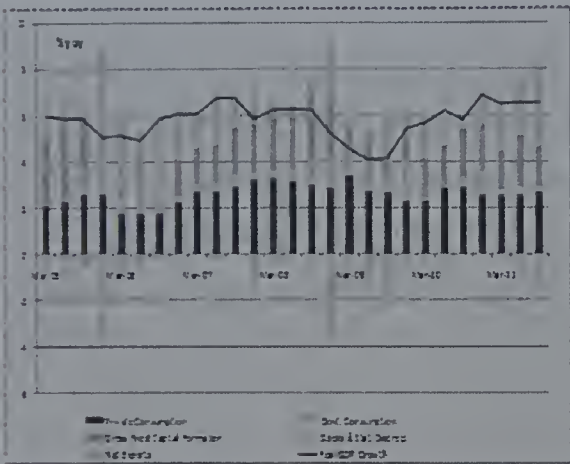
Expenditure Side

On demand side, increases in private consumption, fixed investment, and net exports were the main contributors to the strong growth that occurred in the first nine months of 2011. Underpinned by easing inflation, improving consumer confidence, and growing employment, private consumption grew by an average of 4.6 percent and contributed 40.1 percent to total GDP growth. Fixed investment, driven by strong investment in building construction, grew at average of 7.9 percent and accounted for almost nearly a 2 percentage point increase in GDP growth in the first three quarter of 2011. The improvement in domestic and global investment climate, rupiah appreciation and robust credit growth supported this healthy rise in investment.

Net exports were the largest contributor to GDP growth, while the government spending made a small contribution to overall growth in January to September 2011. Net exports charted the highest growth at average of 22 percent and added nearly 32.4 percent, providing the largest contribution to total GDP growth in the first nine months of 2011. This strength in real net exports was due to strong gains in commodity and agriculture exports, particularly to Japan, China, and India. By contrast, real government consumption made a minor contribution to total GDP growth, reflecting the continuous disbursement in capital spending problems. The growth of government expenditure was on average 3.2 percent and contributed only 3.7 percent to overall

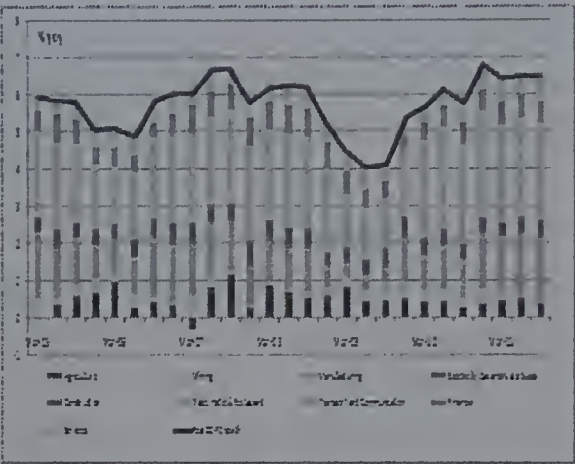
GDP growth in January-September 2011, slightly improved on its -0.79 percent contribution in 2010.

Figure 2a. Expenditure contribution to growth



Source: CEIC Database

Figure 2b. Value added contribution to growth



Source: CEIC Database

Production Side

On the supply side, growth in the first nine months 2011 was driven by manufacturing, transport and communication as well as retail and wholesale trade, reflecting strong domestic demand. The manufacturing sector led by textiles, iron, and steel, performed strongly during the last 6 years, growing by an average of 6.1 percent and contributing to 1.6 percentage points of overall GDP growth. This strong result was buoyed by domestic demand and exports, despite the supply disruptions related to Japan’s earthquake and subsequent tsunami in March. Meanwhile, the trade, hotel, and restaurant sector grew by an average of 9.2 percent, and transportation and telecommunication services grew at an average rate of 11.2 percent during January to September 2011.

On the contrary, mining sector growth slowed and the agriculture sector was relatively stagnant. Mainly due to a decline in oil production, year-on-year the mining sector grew by an average of 1.76 percent in the first nine months 2011, down from an average growth of 3.6 percent in 2010. Meanwhile, better weather than the previous year has lifted the agriculture sector growth to an average of 3.3 percent in

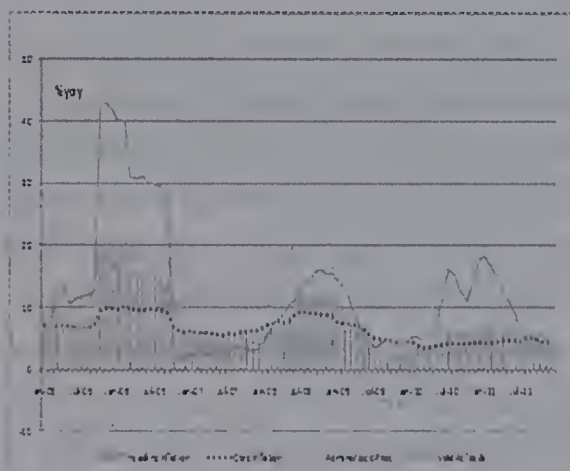
the first three quarter of 2011, up from 2.8 percent in 2010. These two sectors contributed only an average of 0.14 of a percentage point and 0.46 of a percentage point respectively to overall growth rate during January- September 2011.

Monetary Development

Inflation

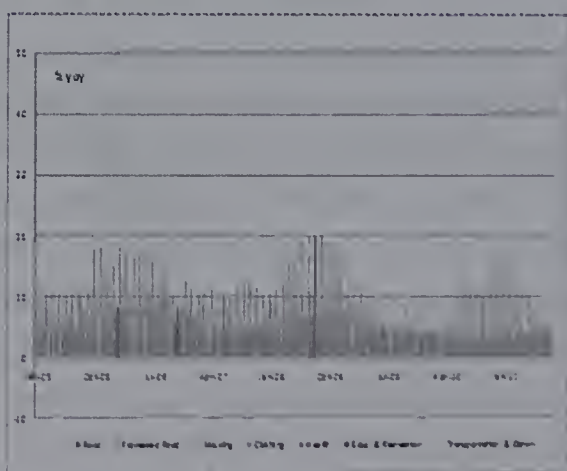
Inflation remain benign over 2011, despite upside inflationary pressures at the beginning of the year. After reaching a early peak of 7.02 percent in January 2011, Indonesia's yearly CPI headline inflation continued to ease to a 20-month low of 3.79 percent in December. Overall, the headline inflation in 2011 was equivalent to its yearly inflation rate of 3.79 percent in the last month of the year. This full-year inflation in 2011 was far below both the government's 5.65 percent target and the central bank's 4 to 6 percent target range, thanks to a decrease in volatile food prices, rupiah appreciation and the absence of government decisions in the fuel price policy.

Figure 3a. Inflation



Source: CEIC Database

Figure 3b. CPI Inflation component



Source: CEIC Database

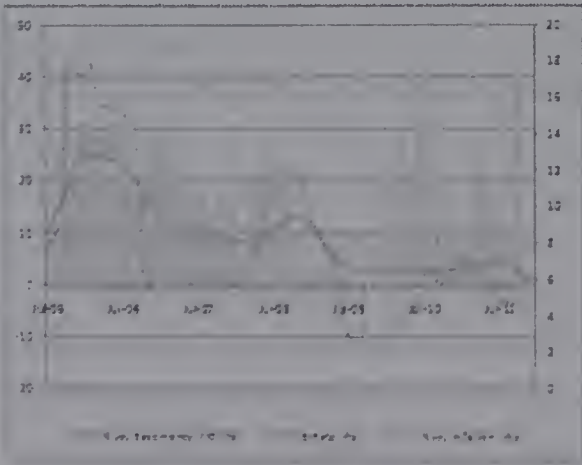
Inflation across the components of the CPI showed mix movement over 2011. Reflecting the pass-through effect of international and domestic commodity prices or the potential emergence of capacity constraints, the core inflation initially increased gradually from 4.18 percent in January to its peak 5.15 percent in August, before gradually

weakening again to 4.34 percent in the last month of 2011. After lifting slightly from 5.21 percent in January to 5.61 percent in July, the administered prices growth continued to slow to 2.78 percent in December 2011 due to the absence of any reforms to the prices of subsidized energy that offset the previous increase in the cigarettes and water billing rates. Meanwhile, the volatile food price inflation slowed from its peak 18.25 percent in January to 3.37 percent in December, attributed to a good harvest as well as government measures to suspend import duties on some food items and to expand rice-distribution to the poor.

Monetary Policy and Banking

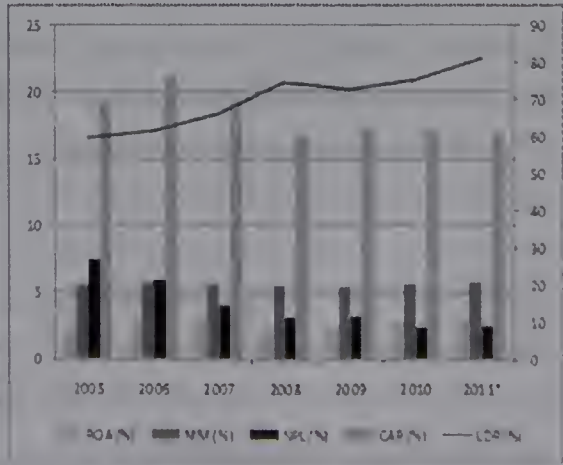
With inflationary pressure subsiding and the risks of global financial crisis rising, in recent months the Central Bank eased its monetary policy. Reversing the 25 bps hike in February 2011, Bank Indonesia took a “preemptive” move by cutting its policy rate (BI rate) by 25 bps in October and another 50 bps in November to a record low of 6 percent. The decision reflected a shift in BI’s focus from fighting inflationary pressures to dealing with the expected slowing economic growth on the back of the European debt crisis and slowing US recovery, which would adversely impact Indonesia’s exports. Furthermore, this stance also reflected BI’s unease over the costs associated with maintaining high interest rates amid the recent backdrop of low global interest rates and excess liquidity.

Figure 4a. Inflation, base money growth, and BI rate



Source: CEIC Database

Figure 4b. Banking performance indicators



Source: CEIC Database

This decision was also part of the efforts to improve short-, medium-, and long-term interest rate structure and was in line with BI's intention to help commercial banks lower their interest rates. It is hoped that lower borrowing cost will help mitigate a weakening global economy and keep the country on a strong growth path, as weaknesses in Europe and the United States threaten to drag the country economy down.

Meanwhile, the Indonesian banking sector remains healthy and resilient, despite growing global financial uncertainty. Up to November 2011, the aggregate return on assets (ROA) was 3.1 percent, the capital adequacy ratio (CAR) was 16.61 percent, the non-performing loan (NPL) was 2.02 percent, although the loan to deposits ratio increased to 81 percent from 75.2 percent in 2010. Nevertheless, net interest margin (NIM) was still relatively high, despite BI's aggressive move in cutting the key rate. The NIM of commercial banks in Indonesia was 5.91 percent in November 2011.

Balance of Payment

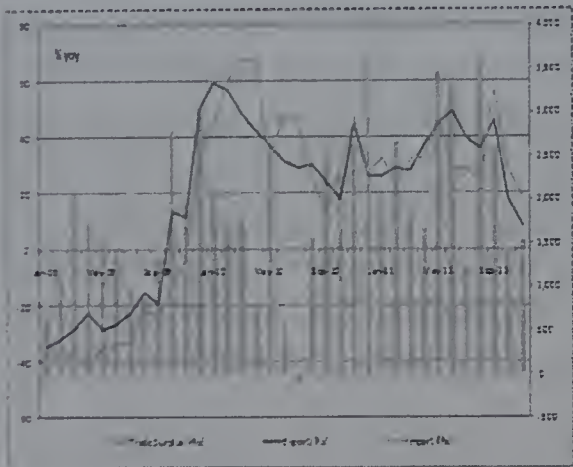
Exports and Imports

Exports in 2011 remained buoyant, despite slowing growth in recent months. Up to November 2011, Indonesia's cumulative exports topped US\$ 186.11 billion, up 32.04 percent compared to the same period a year earlier. Nevertheless, due to a decline in export from ailing US and Europe, monthly export growth has weakened since September 2011 by an average of 3 percent, after recording the biggest export value in history in August. Overall, despite this declining trend, it is expected that the government's exports target of US\$ 200 billion for 2011 is likely to be achieved given the relative strength of November's year-to-date exports performance.

Imports also rose in 2011 in line with the increasing trend in export and domestic demand. Indonesia's cumulative imports in January-November 2011 increased slightly less than that of exports at 31.4 percent to reach US\$ 160.96 billion. The increase was mainly driven by strong demand for capital and intermediate goods, particularly from the manufacturing industry.

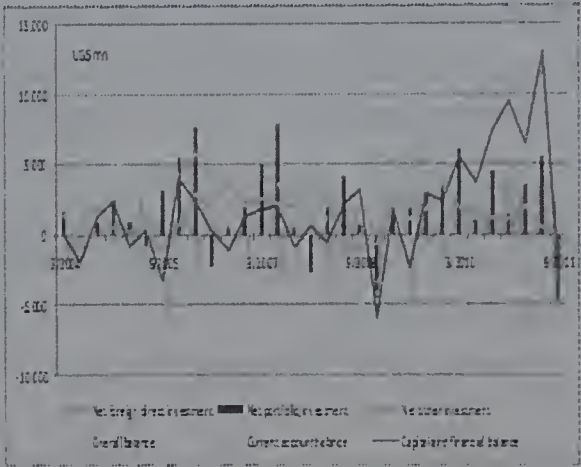
All in all, Indonesia recorded trade surplus of US\$ 25.4 billion, 37.7 percent from the same period in the previous month. It is important to note however that the trade surplus has been narrowed in recent months as the decline in export growth outpaced imports. After reaching a peak of US\$ 3.6 billion in August, Indonesia’s monthly trade surplus declined continuously to reach its lowest level in a year at US\$1.5 billion.

Figure 5a: Nominal trade growth-Merchandise



Source: CEIC Database

Figure 5b. Current, Capital, & Financial Account exports and imports



Source: CEIC Database

Current, Capital, and Financial Account

Reversing the buoyant performance in the first half of 2011, Indonesia’s overall balance of payment recorded a deficit of US\$ 4.0 billion in the third of 2011, the first quarterly deficit since the height of the post-Lehman financial crisis in the fourth quarter of 2008. The deficit was driven by sharp reversal in portfolio capital outflows over August and September, as offshore investors sold down Indonesia’s stock and bonds to chase safe-haven assets, amid rising uncertainty surrounding the Euro zone debt crisis.

The financial and capital account entered negative territory in Q3-2011, while at the same time the current account surplus continued its declining trend since Q2-2011. Financial outflow recorded US\$ 3.4 billion in Q3-2011, compared to US\$ 13.1 percent inflow in Q2-2011. While FDI inflows declined to US\$3.7 billion in Q3-2011 from US\$6.1 billion

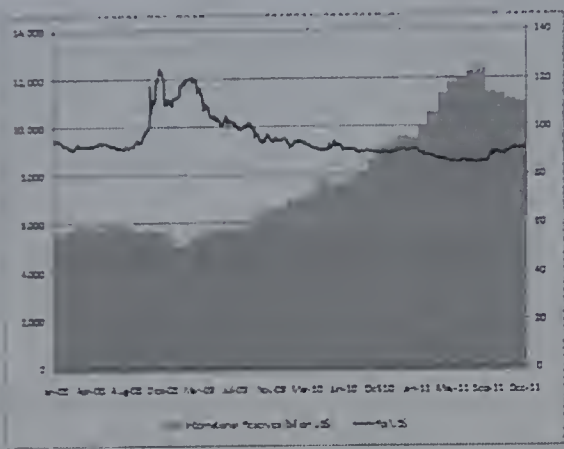
in Q2-2011, portfolio investment recorded a net outflow of US\$4.7 billion in Q3-2-11, following the net inflow of US\$5.5 billion in Q2-2011. Meanwhile, the current account surplus declined from US\$0.5 billion in Q2-2011 to US\$0.2 billion in Q3-2011.

Money Market and Capital Market

Indonesia's financial and stock markets were in an up-and-down movement through 2011, causing both periods of gains and losses. Initially, a rapid influx of foreign funds to the country lifted the rupiah by more than 6 percent to its highest level in a year at Rp8,460/US\$ in early August. Afterward, however, rupiah faced downward pressure as investors dumped rupiah-denominated assets to chase safe-haven assets, including the US government securities bond. Finally, the rupiah depreciated by 1 percent from its initial level in January, closing at Rp9,068/\$US. Rupiah depreciation, however, was still lower than a 2.3 percent drop in South Korea's won, a 3.2 percent slide for Malaysian ringgit, a 3.9 percent fall for the Thai Baht, and a 15 percent decrease in India's rupee.

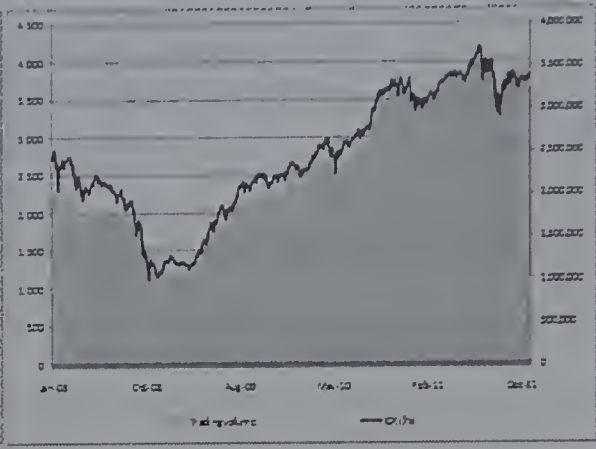
Similarly, the domestic stock market also showed mix movements over 2011, driven by the movement of foreign capital. The Indonesia Composite index (IDX) closed 2011 up only by 3.2 percent, after initially rising by 12.5 percent from its early level in January to its new all-time record of nearly 4,200 in early August. Negative external sentiment, involving the ratings downgrading faced by some countries, the uncertainty over debt limit in the US, the European debt settlements, as well as the foreign companies' action to consolidate their profits, has outweighed the recent good news on Indonesia's sovereign rating upgrade and the passage of long-awaited land acquisition law.

Figure 6a: Rupiah exchange rate and official reserves



Source: CEIC Database

Figure 6b: IDX and trading value



Source: CEIC Database

Outlook 2012: Prospects and Challenges

The outlook for 2012 remains clouded by the uncertainty over Euro zone debt crisis and the slow recovery in US. While Indonesia’s domestic drivers of growth, namely, its solid fiscal position, accumulation of foreign reserves, and strengthened financial performance make the country relatively well-placed to deal with potential unexpected external shocks, the country has not been totally immune from the negative effects of global economic woes as suggested by the recent decline in its export performance and the downward pressures on its currency and equity markets.

Although Indonesia’s economic outlook in 2012 is expected to remain bright, falls in external demand, lower commodity prices, as well as potential sharp capital outflow reversal would continue to function as downside risks to this forecast. Table 1 below shows the projection of some Indonesia major economic indicators conducted by Government of Indonesia, Bank Indonesia and major international institutions.

Table 1. Macroeconomic Outlook for 2010 and 2011

	Government Budget		Bank Indonesia		World Bank		IMF		ADB	
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011
GDP Growth (%)	6.5	6.7	6.5	6.3-6.7	6.4	6.2	6.4	6.3	6.6	6.8
Inflation (% avg.)	5.7	5.3	5 ± 1	4.5 ± 1	4.1	5.6	5	6.4	5.8	5.4
Budget balance (% to GDP)	-2.1	-1.5	-2.1	-1.5	-2.1	-1.5	-1.3	-1.3	-2.1	-1.5
Exchange rate (Rp/US)	8,700	8,800	-	-	-	-	-	-	-	-
Interest Rate (% 3 month)	5.6	6.5	-	-	-	-	-	-	-	-

Source: Collected from various sources

In line with high levels of uncertainty in the Euro zone debt settlement and fiscal problems in Europe and the US, Indonesia GDP growth in 2012 is likely to slow, growing at a rate of 6.3%-6.7%. The fall is expected to be led by poorer export performance caused by slower external demand and lower global commodity prices. Further deceleration is likely to be limited as domestic demand is expected to remain strong. Private consumption is projected to remain robust in the forecast period, on the back of sustain consumer confidences and rising employment and wages, as well as the country’s expanding middle class.

The investment outlook for the next 12 months is also likely to remain favorable, underpinned by global demand for Indonesia’s agriculture, energy, and mineral commodities, continuing FDI inflows, and sustained macroeconomic stability. Furthermore, improvements in the investment climate, reflected in investment grade status and the enactment of new land acquisition laws, along with other planned structural reforms and increasing infrastructure spending is also expected to expand private investment opportunities.

Government fiscal policy is also likely to be supportive for economic growth in 2012, although it remains conservative. Total expenditures are planned to rise by 7.4 percent compared to the 2011 budget, and the budget deficit is targeted to be at 1.5 percent of GDP, down from 2.1 percent in the previous year budget. While the allocation of capital and personnel expenditures increased by 19 percent respectively, the sizeable cost of energy subsidy will remain, despite plans to increase base electricity tariffs by 10 percent and limit fuel subsidies. The budget allocation on fuel subsidies was Rp124 trillion or 13 percent of total

central government spending. All in all, however, the 2012 budget will supports goals of the Master Planned for the Acceleration and Expansion of Economic Development 2011-2025 (MP3EI) to increase capital spending, expand social programs, and accelerate poverty reduction.

On the production side, sectors focused on domestic demand would remain the major contributors to growth in 2012. Activities in trade, hotel and restaurant sectors, transportation and communications, along with construction, are likely to remain buoyant. Manufacturing growth is still expected to continue its progress in 2012, despite some slowing in comparison to 2011 due to fall in global growth outlook. Agriculture, meanwhile, is predicted to chart stable growth after taking account of a number of programs prepared by government in anticipation of climate change, balancing fall in global demand and commodities prices.

Regarding the price, the "moderate" inflationary pressures that persisted last year are likely to continue through the first quarter of this year until the government realized its plans to increase base electricity tariffs and limit fuel subsidies. After factoring in 10 percent increase in base electricity tariffs and limit fuel subsidies plan for April, it is expected that the headline inflation would remain relatively benign at around 5 percent by the end of this year, as slowing global growth weighs on commodity prices. This rate is likely still well within the central bank's 3.5 to 5.5 percent target. It is worth noting however that potential domestic rice supply shocks caused by unpredictable weather condition could put upward pressure on prices. Moreover, BI's policy stance is also a key factor in maintaining control over inflationary pressures, as the change in policy rate, to certain extent, influence price expectations and lending conditions

Although the recent easing inflation trend has provided more room for further rate cuts, the BI rate is likely stay at the current level of 6 percent for sometimes in the future. The rate is likely to be kept steady to remain competitive with interest rates in developed nations, especially in the United States, maintaining the attractiveness of Indonesia portfolio assets. Nevertheless, it may be cut further to 5.75 percent and remain there if inflation falls and the pressure on rupiah eases. For the time being BI will maintain its "counter-cyclical" monetary policy mix and macro-prudential against the backdrop of the volatile financial

market which might affect negative perceptions for the real sector.

The recent declines in commodity prices and portfolio flows to emerging markets, together with the deterioration in global demand are expected to led to a narrowing of the balance of payment surplus. The current account is likely to continues its downward trend and reached negative territory in 2012. This reflects a lowering of the rated surplus due to weaker external demand and commodity prices combined with strong imports growth, along with a continued income deficit consistent with increasing FDI flows to Indonesia and the repatriation of related corporate earnings. Reversing the recent outflows, however, portfolio inflows are expected to return in 2012 although they are remain volatile in the near-term. Furthermore, FDI inflows are also likely to remain solid in 2012 as the offshore companies continue to be attracted to Indonesia's growing domestic market.

On domestic equity market and rupiah exchange rate, sour global sentiment surrounding Europe debt crisis is expected to continue driving down Indonesia's stock market and rupiah in the short term as Indonesia faces high exposure to foreign funds in its bond and equity assets. Nevertheless, underpinned by domestic stock market movement the rupiah may perform well in 2012 and the country currency may even further strengthened in 2012 on the back of strong economic growth, low interest rate, moderate inflation, a credit rating upgrade and state construction spending.

The Year of Living Dangerously for Certain Minority Groups

*Philips J. Vermonte*¹

Entering 2012, we find that are now only 2 years away form the next general election which will take place in 2014. The election in 2014 will be the fourth democratic election in Indonesia since 1998. After experiencing a long period authoritarian governance, the achievements of three democratic elections are very notable. It is widely appreciated that Indonesia has become more democratic.

However, there remain several tasks that need to be done. In the past three months, several worrisome issues have arisen which may put a halt to Indonesian democracy. The country witnessed vertical as well as horizontal conflicts and violence returned in some places caused by different reasons.

Conflicts and Violence

Violence towards small minority groups remained a scar on Indonesian democracy and the spirit of pluralism leading up to early 2012. In early 2011, Indonesia was shocked by the violent attacks on the follower of *Ahmadiyah* group in Cikeusik, Pandeglang, Banten. This was considered as a bad news for democracy, the principles of pluralism and the purpose of Indonesian nation. President SBY expressed his sympathy however he failure to attempt any real handling of the issue.

The attack on the Shiite Islamic boarding school in Madura, and the continued ban on the GKI Yasmin church's activities in Bogor in December 2011 and January 2012, indicate that religious intolerance is on the rise. Once again, President SBY only expressed his sympathy

¹ Philips J. Vermonte is Head of Department of Politics and International Relations, CSIS

but failed to deliver the message that violence towards any group by party will not be tolerated.

The conclusion, however, should not be that this was a failure on the side of the state - Indonesian society also failed in protecting and declaring pluralism as the key component of democracy. For the minority groups in Indonesia that suffered as a result of those violent acts, the year 2011 could be considered as *the year of living dangerously*. The state, to a certain extent, lost its grip on the use of violence by various non-state actors.

It should be understood that Indonesia is still undergoing the process of democratization and massive political and social reforms. A State is a social organization that has layers of bureaucracy that are always in the process of evolving and changing. Under such circumstances, the state seems not to be the only actor when it comes to the monopoly in the use of force and (legitimate) violence.

In the process, the state interacts through its apparatus with various social forces. These social forces also compete among themselves to create domination to resources and control over society. State and society interplay with each other.

This approach leads us to think further about the issues of violent acts toward the minority groups. *What factors made President SBY and state apparatus (police force) fail to anticipate and deal with the violence?*

Indonesia today is relatively stable financially. It is too early to conclude that the violent acts indicate the failure of Indonesia as a state. However, so far the political elites have not spoken with a unified voice and dealt with the violence toward minority groups. As a democratic state, this showed a back step in promoting pluralism. Some of these elites made the situation worse by placing the blame on the victims. The attitudes of the elites incited several anti-pluralism groups in society to mobilize and justify violent acts toward others.

In light of the fact that Indonesia is now more decentralized, the violent incidents showed that the central government was not the only responsible actor. The local government also failed in promoting pluralism and democracy at a local level. Democracy does not only mean the freedom to give a voice in the general election, but also the responsibility to adhere to democratic principles, including law enforcement, human rights protection, and other basic freedom.

The attitude of *blaming the victims* was not only popular among the elites. The Indonesian society in general also tends to display the same attitude. As a result, the society has failed to send a strong message to the government and state apparatus that any violent acts toward any minority group should not be tolerated.

As a result of the idea of fragmented state and society, the state (which represented by President SBY as the head of the state, and the Chief of Indonesian Police Force (*Kapolri*) as the state commander of legitimate use of violence) failed to protect minority groups from any violent in the name of *majority*. Thus, the main factor of the 'absent' state was a weak leadership in the government level.

Vertical conflict —between state and society- is another worrisome development. In Bima (within the West Nusatenggara province), local people protested the continued operation of a mining company (which is PT Sumber Mineral Nusantara - SMN) and called for the termination of the company's operation. The protest turned into violence as the people burned down the regent and local election offices. The raging mob was reacting to the local government's slow response to its demand on the termination of PT SMN's operation. After the strong opposition from the local people, the Bima regent revoked the mining permit that was granted in 2010. As a matter of fact, the violent incident was a continuation of the clash between the local people and police few weeks earlier when the people blockaded the Sape port on the same demand.

In the Papua province, shooting incidents in various places have also been continuing. It sparked questions regarding the seriousness of the central government in Jakarta in implementing special autonomy status in the region. As reported by the media, the shootings have been taking place since 2009, leading to the deaths of at least 15 people and injuring many more. The fact that the security apparatuses could not locate the perpetrators has triggered speculations that the violent incidents were politically motivated with the objective of prolonging insecurity in the province thus keeping the province's situation as a conflict-prone area.

In addition, a recent survey conducted jointly by the Partnership for Governance Reform (Kemitraan) and the Legal Aid Institute (LBH) in Jakarta and Papua revealed that torture and other forms of violence

have been persistently used by legal enforcement institutions in Papua to force detainee to admit alleged crimes.

Leadership: Parliament and Political Parties

The DPR RI showed limited performance in the legislative process. During 2011, the DPR succeeded in producing only eleven laws from thirty-seven drafts from *Daftar Prolegnas* (the list of national legislation program in total. For 2012, DPR claimed a target of forty-eight laws. Judging from their performance in 2011, this target seems to be too ambitious. For their priorities in the year 2012, the DPR will attempt to produce several laws, namely: amended laws on national and local legislative elections, a law on national security, amending law on the presidential election.

The appreciation needs to be given for PDI-P, which consistently decided to stay outside the government during two periods of President SBY. PDI-P has shown that being an opposition is one significant way to build democracy in Indonesia. Although financially it is difficult, PDI-P has succeeded to survive as a political institution without any governmental power and still keeps the chance of internal consolidation. If PDI-P is able to capitalize on the experiences of being on the opposition side, they have a good chance of performing well in the 2014 election.

The incumbent party, PD, continues to be marred by internal conflicts related to the high profile corruption cases in which some its high ranking officials are implicated. While the position of Anas Urbaningrum as the party chairman once seemed to be in jeopardy, President SBY as the party's patron eventually sided with him. It gave Mr. Urbaningrum renewed support from the members of the party. Nevertheless, the end of the corruption saga involving the former Treasurer of PD, Muhammad Nazarrudin, Mr. Urbaningrum himself, other party members who are also the member of DPR Mirwan Amir and Angelina Sondakh, and Youth and Sports Minister Andi Mallarangeng, remains to be seen.

Leadership: President SBY and others

According to a recent survey by LSI, the popularity of President SBY has decreased significantly. It somehow showed the *lost opportu-*

nity for the two-term president. When President SBY was re-elected with a significant number votes in 2009, he had the necessary legitimacy to bring politics and democracy in Indonesia to a higher level. His campaign promised to eradicate corruption seemed to be nullified by the fact that the people who committed several high profile corruption cases were his own party members.

The SBY-Boediono administration was also challenged by their coalition. The unstable coalition, which struggled on various interests, survives so far due to their common interests to remain in power in order to obtain access to state resources. It is widely reported that some of the political parties that support the coalition are also involved in many cases of corruption.

By the end of the 2011, almost all political parties that hold seats in the DPR have had their annual national meetings. During the meetings, the political parties have revealed their preferred presidential candidates for the 2014 election.

PDI-P undoubtedly would pick Megawati Soekarnoputri as its preferred presidential candidate. It must be noted, however, that some manoeuvres within the party have attempted to elevate her daughter, Puan Maharani, to the party's top position. Ms. Maharani, for example, has been installed as the chairwoman of PDI-P's faction in the DPR. This move by the party has been viewed as an attempt to increase Ms. Maharani's political clout within the party's rank and file. It can also be considered as a necessary move to increase Ms. Maharani's political leverage for the 2014 presidential election.

Lastly, in 2011, several young politicians, who used to be the promising 'next' generation in Indonesian politics, were implicated in many high profile corruption cases. These young politicians were actually holding some key positions in their respective parties, including chairmen, members of the DPR. Young politicians from the incumbent party, PD, PKB and some other parties are among those involved.

To sum up, the year 2011 indicated the weak leadership of the executive (President SBY) and the legislative (DPR). Pluralism has been threatened, while violent acts in politics, ethnic, and religious aspects have increased.